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ABSTRACT

Some of the strategies that states have used to manage budget shortfalls are presented in this report. It provides information, evaluations, and case studies that policymakers can refer to when considering their options, and it emphasizes strategies to manage budget shortfalls, which tend to need a quick resolution. The report also examines some state actions that are intended to have a longer-term, positive effect on state budget management. The report begins with a definition of a budget shortfall, followed by an examination of the causes of such a condition. It explores various management efforts such as cutting the budget and raising revenue. Case studies show how states have avoided or minimized shortfalls and have reduced state spending in major program areas using such strategies as privatization and early retirement. Chapter 4 considers the area of K-12 education and provides a case study of "K-12 School Foundation Aid Reductions in Vermont" (p.25). (RJM)

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STATE STRATEGIES TO MANAGE BUDGET SHORTFALLS

Foundation for State Legislatures
and
National Conference of State Legislatures

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December 1996

The National Conference of State Legislatures serves the legislators and staffs of the nation's 50 states, its commonwealths, and territories. NCSL is a bipartisan organization with three objectives:

- To improve the quality and effectiveness of state legislatures,
- To foster interstate communication and cooperation,
- To ensure states a strong cohesive voice in the federal system.

The Conference operates from offices in Denver, Colorado, and Washington, D.C.

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PREFACE AND ACKNOWLEDGMENTS

In mid-1991, several members of the Foundation for State Legislatures convened to discuss how they could assist in the development of sound state fiscal policy. They concurred that they could pool their resources to examine specific areas of state tax policy and then make recommendations. This group, known as the Foundation Fiscal Partners, supports the Fiscal Affairs Project, a continuing effort to increase, enhance and communicate state fiscal information.

One of the goals of the Fiscal Affairs Project is to improve the dialogue among state legislators, business representatives and other organizations interested in decisions on state fiscal policy. By increasing awareness of different perspectives and improving communication among the participants, these groups can develop an effective partnership to address such concerns as fair and stable tax systems and sound budgeting practices.

The Fiscal Affairs Project has supported the work of the NCSL Fiscal Affairs Program in several ways. Most notably, the project has produced three major publications: (1) *Principles of a High-Quality State Revenue System*; (2) *Fundamentals of Sound State Budgeting Practices*; and (3) this report, *State Strategies to Manage Budget Shortfalls.*

State Strategies to Manage Budget Shortfalls is the work of many contributors: legislators, legislative staff and representatives from the Foundation for State Legislatures. Besides drawing upon the expertise of those who directly participated, the NCSL staff who wrote this report relied on numerous state experts including several NCSL staff with substantive knowledge and expertise on specific state programs.

Corina Eckl, Scott Mackey and Ronald Snell are the principal authors of this report. Other fiscal staff contributing to this report were Arturo Pérez and Mandy Rafool. Any views expressed in this report are the responsibility of the authors and should not be attributed to the participating legislators, legislative staff or sponsoring organizations.

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Tennessee's Oversight Committee on Corrections, Susan Smith of Tennessee's Fiscal Review Committee and Robin Lubitz of North Carolina's Sentencing and Policy Advisory Commission. The NCSL staff assisting with this report were Julie Bell, Brooke Davidson, Martha King, Donna Lyons, Elizabeth Pearson, Laura Tobler, Jack Tweedie, Terry Whitney, Adelia Yee and Judy Zelio.

The authors also extend special appreciation to Carolyn Alvarez for her expert preparation of the text and tables for this report, to Karen Fisher for her comprehensive and precise editing and to Bruce Holdeman for his cover design.

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EXECUTIVE SUMMARY

There are many causes of state budget shortfalls, and, because they are interrelated, several often arise simultaneously. The chief causes are weak economic performance, inaccurate revenue and expenditure projections, state tax policies such as excessive use of tax earmarking, state expenditure policies such as unchecked program spending, federal actions such as the imposition of unfunded mandates and court decisions such as those imposing substantial funding obligations on the states.

There are two kinds of budget shortfalls: (1) short-term, temporary shortfalls that result from economic cycles or imprecise revenue or expenditure forecasts and (2) structural shortfalls that result from expenditure growth routinely outpacing revenue growth.

Although policymakers' strategies to resolve budget shortfalls vary, they have a predictable pattern. State officials impose short-term or stop-gap measures, cut the budget, increase revenues or impose some combination of these strategies. Generally, the selection of a strategy depends on the amount of time remaining in the fiscal period, the severity of the shortfall and other actions that have been taken.

Short-term strategies are not intended to deal with fundamental budget problems and may generate only one-time savings or revenues. Their chief advantage is that they typically have an immediate effect on a budget problem. Examples of short-term measures include delaying payments to vendors, deferring tax refunds and accelerating tax collections.

States may also turn to temporary budget cuts to deal with shortfalls. Again, the impact is immediate because the level of state spending is adjusted to fall within estimated available revenues by the end of the fiscal year. Budget-cutting exercises also may provide policymakers with an opportunity to seriously review spending priorities.

Policymakers may opt to raise revenues to deal with budget shortfalls. These revenues may be one-time (e.g., revenue from tax amnesty programs) or long term (e.g., permanent increases in the sales tax rate).

To limit the need to cut the budget or raise taxes, many states have implemented procedures intended to avoid or minimize shortfalls. Among the most common measures are limiting appropriations to a percentage of revenue estimates, imposing contingency budget reductions or trigger mechanisms and creating budget stabilization funds.

In addition to short-term strategies to address budget shortfalls, states also may seek permanent spending reductions in major program areas. Most spending is for elementary-secondary (K-12) education, Medicaid, higher education, corrections and welfare. In combination, these program areas account for about 70 percent of state general fund

spending. As a result, policymakers are apt to consider these areas when budget cuts appear inevitable. States have tried strategies that include reducing K-12 foundation aid, implementing Medicaid managed care programs, reducing state funding for higher education, privatizing prisons and implementing welfare reform.

State policymakers also consider expenditures that cut across program lines when implementing budget reductions. For instance, 20 percent of all state spending goes for government employees. To reduce personnel costs, states often implement early retirement programs or privatize certain services. State aid to local governments is another expense that crosses program lines. When looking for aid reductions, states have reduced general purpose revenue sharing or have identified another source of funding to replace state support.

This report explores a variety of strategies that states have used to manage budget shortfalls. It provides information, evaluations and case studies that policymakers can refer to when considering their options. Recommendations regarding which actions to take are not included because lawmakers must assess the potential effectiveness and political feasibility of various options in view of the social, economic and political context of their respective states.

INTRODUCTION

Budget shortfalls are an inevitable occurrence in government finance. Because revenues are tied to the business cycle, economic declines will cause revenues to fall. At the same time, demand for government services typically increases during economic downturns, often pressuring state officials to spend above budgeted levels. Even sound state fiscal planning and management cannot save states from dealing with the effects of business cycle declines, although they may minimize the adverse effects of those declines or buy a state time to make better informed fiscal decisions.

What Is a Budget Shortfall?

A budget shortfall occurs when spending exceeds revenues during a budgeting period (fiscal year or biennium). As discussed in greater detail in chapter 1, shortfalls occur because:

- Revenues do not materialize as projected;
- Spending exceeds originally appropriated levels;
- Some combination of lower-than-expected revenues and higher-than-expected spending occurs simultaneously; or
- State reserves or other potential revenue sources are insufficient to cover planned or unplanned spending.

This report is concerned with general fund budget shortfalls that have the potential of becoming year-end deficits. There are two kinds of budget shortfalls: (1) short-term/temporary shortfalls that result from economic cycles or imprecise revenue or expenditure forecasts and (2) structural shortfalls that result from the growth of expenditures routinely outpacing the growth of revenues. This report reviews strategies for dealing with both kinds of shortfalls.

Purpose of This Report

Because most states operate under a constitutional or statutory requirement for a balanced budget, strategies to avoid a deficit are required in most states. The purpose of this report is to explore these strategies. Although fiscal crises can provide opportunities and options for dealing with the state budget that may have been rejected during times of fiscal stability, eliminating a budget shortfall is no easy task. This report will not make the task of addressing budget shortfalls any easier, but it provides useful information and evaluations as policymakers consider options to eliminate shortfalls. It also includes specific state experiences with those strategies.

This report does not make recommendations regarding which actions to take because lawmakers must assess the potential effectiveness and political feasibility of various options in view of the social, economic and political context of their respective states. Furthermore, this report does not attempt to assess the various philosophies on the appropriate role of government: The size of state government and the level of services provided are issues to be determined by the elected officials and citizenry of each state.

This report emphasizes strategies to manage budget shortfalls, which tend to need resolution within a short period of time. It also looks at some state actions that are intended to have a longer-term, positive effect on state budget management.

Short references to relevant publications are included in the text; full citations are contained in the Select Bibliography contained at the end of the report.

As previously noted, budget shortfalls often are the result of both revenue decreases and expenditure overruns, so state officials must consider both sides of the ledger when attempting to eliminate budget shortfalls. This report focuses only on budget strategies to manage shortfalls because good sources of information on revenue options already are available. *State Tax Actions*, an annual series of reports produced by NCSL, provides a comprehensive list of state tax actions over the past decade. *Financing State Government in the 1990s* also provides a comprehensive discussion of state revenue issues.

1. CAUSES OF BUDGET SHORTFALLS

There are numerous causes of budget shortfalls, and they are interrelated. This chapter provides an overview of the chief causes of state budget shortfalls:

- Economic performance;
- Inaccurate revenue and expenditure projections;
- State tax and expenditure policy;
- The effects of federal actions on state budgets; and
- Court decisions.

Economic Performance

National and regional economic performance are the most important external influences on state finances. The normal business cycle includes economic declines, troughs, recovery periods and peaks that subject state finances to unpredictability.

Although there may be time lags, when the national economy declines, finances in most states also decline. Likewise, a national recovery tends to help most states' finances to rebound. As evidenced by state fiscal conditions during the recessions in the early 1980s and early 1990s, the health of most states' finances can be traced directly to fluctuations in the business cycle (see figure 1).

Inaccurate Revenue and Expenditure Projections

Because of the unpredictability of the economy and the uncertainty surrounding the duration of business cycle phases, state budgeters are left with the very difficult task of accurately estimating both revenues and spending needs. The problem is exacerbated when the economy is in a recession, because revenues are likely to be falling at the same time that demand for government services is increasing.

Inability to make accurate revenue projections

State revenue forecasters recognize they have an especially difficult task—to accurately project revenues when the economy is unpredictable. Though their projections are certain to differ from actual collections, the question is, to what extent. Under the best conditions, forecasters' projections may be within a couple of percentage points of actual revenues. But when the economy is changing rapidly, the difficulty of making a reasonably accurate projection increases. This is especially true for projections that apply to revenue collections 12 to 18 months in the future. That is why some states have shifted the frequency of their estimates from annual or biennial schedules to semi-yearly or quarterly. Frequent forecasts,

Figure 1. State Year-End Balances as a Percentage of General Fund Expenditures: FY 1978 to FY 1996

Source: National Conference of State Legislatures, *State Budget Actions*, various years

however, may lead to revenue projection adjustments based on one-time events that are not sustained over a longer period.

Forecasters also face the difficulty of making accurate economic assumptions and correctly interpreting economic indicators. One example is consumer behavior, which can be very difficult to predict. Although consumption may be increasing, causing estimators to assume improving sales tax revenues, the nature of the consumption may not support the assumption. In late 1995, for example, consumer spending was very strong, but the purchase of goods was down because consumers shifted their purchases to a wide range of services.[1] Since services typically are not included in state sales tax bases, increased use of services does not increase sales tax collections.

In addition to external factors, forecasts may be subject to political pressures, which may cause the forecast to be overly optimistic to allow a higher level of spending. Or, intentionally low estimates may be made to restrain spending or create a budget surplus. Recognizing the need for accurate revenue projections, some states have attempted to improve the revenue estimating process by using consensus forecasting. A consensus forecast is mutually developed and agreed upon by legislative and executive branch officials; other participants such as business economists or university faculty also may be involved in the process. Consensus forecasts eliminate the time and resources devoted to developing competing forecasts and they attempt to depoliticize the process. (For more information on this issue, see Hutchison, *The Legislative Role in Revenue and Demographic Forecasting*.)

Inability to make accurate expenditure projections

Most state budgets are based on the previous year's budget adjusted to account for assumptions made about inflation, enrollment increases, caseload growth and other factors. Although reasonable assumptions may be made, external factors may cause the estimates to be off target. For example, economic downturns typically increase demand for government services, especially caseload-driven services such as Medicaid and Aid to Families with Dependent Children (AFDC). Such downturns often cause state spending to increase above budgeted levels. Because it is difficult to accurately predict the effects of the economy on state programs, inaccurate spending projections are inevitable.

In addition to external factors, internal pressures may lead to spending projections that are based on unrealistic cuts in programs or unattainable savings. A common example is early retirement programs for state employees. The projected savings from these programs may fail to consider intermediate and long-term costs. This issue is discussed further in chapter 5.

To improve expenditure estimates, more states are implementing expenditure forecasting processes. North Carolina, for instance, has developed a forecasting model for expenditures for 28 state departments over a 10-year period. The state also has implemented a process that estimates how sentencing policies will affect prisoner populations, what such policies mean for long-term prison space and the implications for the state budget (see the case study on page 38). Kansas has taken another approach. Because of its success with consensus revenue forecasting, Kansas has implemented a consensus model to forecast student enrollment numbers and caseloads for social programs to provide policymakers with better estimates of expenditures for those programs.

State Tax and Expenditure Policies

State fiscal policy refers to the state's tax and spending policies. These policies tend to have long-term implications for state budgets and may lead to structural deficits, but they also can cause potential deficits in the short term. State fiscal policy generally is driven by the legislative process, but in a growing number of states, voter-imposed directives and restrictions are increasingly influencing such policy.

Tax Policy

State tax policy decisions affect levels of revenue, taxpayer behavior, the types of taxes that are levied, tax rates and bases, and the overall stability and integrity of the state tax system. Most state tax systems are antiquated—they are not designed to reflect modern economic circumstances and behavior and, without rate increases or base expansions, they do not produce revenue growth that keeps pace with economic growth. Although many policymakers are aware of the shortcomings of their tax systems, they often have been unsuccessful in making adjustments. Specific tax policy problems, such as those discussed below, can contribute to short-term budget shortfalls and structural budget deficits.

Lack of a balanced/diversified tax system. Lack of balance and diversity in a state's revenue system is an important determinant of budget problems. States with narrow tax bases can be particularly vulnerable to shortfalls. States such as Louisiana and Oklahoma, for example, that were heavily dependent on taxes from oil and gas production suffered significant economic declines in the mid-1980s when the price of oil plummeted. (For more information on the importance of tax diversification, see NCSL Foundation Fiscal Partners, *Principles of a High-Quality State Revenue System.)*

More recently, state tax bases have eroded because of the changing nature of the American economy and how consumers spend their money. Specifically, the U.S. economy is shifting from the production and consumption of goods to the production and consumption of services. Over the past decade, some states gradually have extended their sales tax bases to include the purchase of consumer services, such as dry cleaning, landscaping and janitorial services. Generally, however, state tax systems have not been significantly adjusted to reflect the shift to a service-based economy. (For a further discussion of this issue, see *Financing State Government in the 1990s.*)

Some states do not levy certain kinds of taxes, such as income taxes, because of strong tradition or because their state constitutions prohibit them. These states typically have generated tax revenues through reliance on some unique endowment, such as extensive mineral resources in Wyoming or special tourist attractions in Florida.

Tax and revenue limits. In addition to long-time prohibitions on certain kinds of taxes, state policymakers are facing restrictions on revenues and tax increases. Seven states operate under tax or revenue limits or both. Tax limits require that voters approve all or some

portion of tax increases. Revenue limits restrict the amount of new revenue that can be raised each year. Increasingly, voters are imposing these kinds of limits. In 1992, for example, Colorado voters passed a ballot initiative that requires that all state and local tax increases be approved by the voters. Such policies may have long-term implications for a state's ability to generate sufficient revenues to covered desired levels of spending. Moody's Investors Service repeatedly has warned investors of the potential long-term danger of such policies. (For a further discussion of tax limits, see *State Tax and Expenditure Limits.)*

Level of tax effort. Tax effort measures the extent to which a state utilizes its available tax base. The level of tax effort is determined by comparing a state's actual revenues with its estimated capacity to raise revenues. Public finance experts report a low correlation between level of tax effort and budget shortfalls. However, because the tax system must produce sufficient revenues to cover the long-term spending growth that existing policies generate, states with low tax effort may be contributing to a deficit that could be avoided or minimized. (For a complete discussion of tax effort see U.S. ACIR, *RTS 1991: State Revenue Capacity and Effort.)*

Excessive use of tax earmarking. States should have the flexibility to address budget shortfalls using both revenue and budget options. This flexibility is threatened, however, when states make excessive use of earmarking. Dedicating state revenues for specific purposes continues to be a common practice in the states. Proponents argue that earmarking provides an ongoing and continuous level of support for certain programs and often is necessary to win voter approval of a tax increase because the voters know how the new tax revenues will be spent. Opponents of earmarking argue that it limits lawmakers' ability to set budget priorities, especially in the face of budget shortfalls that require budget cuts. One report stated, "Lawmakers are handcuffed by laws that reserve a large portion of the government revenue stream for dedicated uses."[2] (For a further discussion of earmarking, see *Earmarking State Taxes* and *Fundamentals of Sound State Budgeting Practices.)*

Expenditure Policy

State policymakers' spending decisions have both short- and long-term implications for the budget. Some of these decisions are intended to avert budget problems, such as state policies that constrain spending to some level of expected revenues (discussed further in chapter 3). Other policies, however, have led to programs whose costs grow automatically at a rate that tends to outpace revenue growth. These policies are principal contributors to budget shortfalls in the short run and structural deficits in the long run.

Unchecked spending growth

At the same time that states have difficulty accurately predicting spending needs, they often find it difficult to modify programs whose annual costs outpace annual revenue growth, thereby creating a perpetual budget problem. California often is cited as an example of this problem because, according to some observers, the state's current services budget has tended to grow faster than its economy largely because of open-ended entitlements. In recent years California has attempted to get a handle on this problem by reducing welfare grants (pending federal approval), limiting eligibility for welfare programs and aggressively pushing HMOs for health care.[3] Iowa has found itself in a similar situation: A large percentage of its spending, such as state aid to schools, was driven by formulas that were not subject to annual budget adjustments. Recently, more programs have become part of the annual budget review process.

Medicaid spending, in particular, provides the best example of unchecked spending growth in the states. For various reasons, Medicaid's share of state budgets has outpaced state spending for most programs, causing other budget areas, such as higher education, to receive less money. The growth in Medicaid spending has also outpaced the growth of state revenues. Recognizing that Medicaid in particular is a long-term budget problem, some states have sought to control it through initiatives such as managed care. State efforts to control Medicaid costs are discussed further in chapter 4.

Corrections costs also are growing rapidly. State sentencing policies are increasing the number of prisoners and lengthening prison stays, which directly affect state budgets. The future costs of policies such as "three strikes and you're out" will be particularly high.

Guaranteed levels of spending

Favored or high-priority programs may receive minimum or guaranteed spending levels. Like tax earmarking, this practice severely constrains budget flexibility. Such provisions can contribute to a budget shortfall if revenue growth is insufficient to meet the guaranteed level of spending and other planned expenditures. The potential problem is particularly acute when state finances are declining.

Spending limits

Nineteen states operate under some type of spending limit. These limits tie the growth of spending to an index such as increases in inflation or population. Generally, these limits have not been very restrictive because of their design and the ease with which state governments can circumvent them. They may have a greater impact on state finances in the future, however, if the federal government requires states to take on more fiscal responsibilities under devolution. Most state spending limits do not make exceptions for new program responsibilities that may come from the federal government or any need to replace federal funds with state funds. (For a further discussion of spending limits, see *State Tax and Expenditure Limits.)*

Lack of adequate reserves

Reserve, or budget stabilization, funds are important because they can have an immediate effect on a budget shortfall. Their purpose is to help states avoid ad hoc budget or tax decisions. Their ability to address budget shortfalls, however, depends primarily on their size. Wall Street analysts who monitor state finances recommend that states hold reserves equal to 3 percent to 5 percent of state spending. In most states, however, reserves have been well below the recommended level and too small to address sizable or recurring shortfalls. Used in combination with other strategies, however, even modest reserves have been useful. Budget stabilization funds are discussed in greater detail in chapter 3.

The Effects of Federal Fiscal Actions

Federal policy decisions can have implications both for state revenues and for state spending, and often the implications are closely interrelated. On the revenue side, states do not know how much federal aid they will receive. Changes to the federal tax code also may have revenue implications for states. On the spending side, unfunded or underfunded mandates on states may impose significant costs. As discussed later, developments in Washington, D.C., in the late 1990s may exacerbate these problems.

The unpredictability of federal funds

The uncertainty regarding the level and timing of federal funds hampers state forecasters' ability to predict revenue and spending levels. If federal funds do not materialize as expected, the state is faced with the decision of whether to make up the lost funds.

Obviously, a decision to replace the lost federal money with state money can lead to budget problems and a potential shortfall.

Linkages to the federal tax code

Most states link portions of their tax code to the federal tax code. For example, as of January 1, 1996, 36 states and the District of Columbia linked their personal income tax to the federal personal income tax, using either federal adjusted gross income, federal taxable income or federal tax liability as a starting point to determine state tax liability. These linkages mean that changes to the federal tax code automatically affect state revenues. Although this can lead to revenue windfalls, which occurred in many states when the Federal Tax Reform Action of 1986 was passed, it also can lead to revenue shortfalls if the federal government cuts tax rates or increases exemptions and deductions. Although states can increase state taxes to offset such revenue declines, an antitax climate may make that option politically difficult.

Federal mandates

Of perhaps greater concern to the states than the timing and level of federal funds is the problem of federal mandates—requirements that impose programmatic or financial obligations on the states. Although unfunded or underfunded federal mandates on the states are unlikely to cause an immediate budget crisis, they hamper state flexibility and over the long term can lead to serious budget problems. As evidenced in the area of Medicaid, mandates can impose significant costs on the states. A budget shortfall can result if the state's revenue system cannot produce sufficient new revenues to cover the new costs. Another problem arises when a state is forced to use its own funds to provide federally mandated services that are supposed to be reimbursed. California has faced this problem for several years because it has not been fully reimbursed for the costs of programs for immigrants.

The effects of federal fiscal actions are emerging as an important concern in the late 1990s as the federal government seriously examines devolution and the shifting of responsibilities from the federal government to state and local governments. Under some proposals, states would receive more flexibility and less funding. Other proposals would continue existing mandates with less funding. In recognition of the potential financial liability that looms, some states have taken steps to avert or minimize their risk. In Maryland, for example, policymakers eliminated $50 million in federal funds from the FY 1997 budget under the assumption that the state would not actually receive those funds. In FY 1996, Ohio officials created a Human Services Stabilization Fund of $100 million in anticipation of federal budget changes that would impose more responsibilities on the state with no commensurate increase in federal funding.

Court Decisions

Court decisions are another cause of budget shortfalls. On the revenue side, a tax may be ruled unconstitutional, requiring the state to eliminate or change it, thereby causing state revenues to drop. The adverse effect is compounded when court decisions also require monetary relief for back taxes paid. Although states are likely to be alerted to forthcoming court decisions that would adversely affect state revenues, such decisions may still contribute to a budget shortfall if the tax was an important source of state revenues.

Just as court decisions can contribute to budget shortfalls on the revenue side, they also can impose significant financial obligations that were unplanned. Recent and widespread litigation regarding school funding formulas is a common example. Since the early 1980s, more than half the states have been involved in such lawsuits. In mid-1995 alone, 16 states

were involved in some stage of school finance litigation.[4] The decisions in these cases may impose a substantial funding obligation on the states because most of the lawsuits deal with the question of equitable and adequate spending per pupil. As a rule, this has meant that states spend more because they "equalize up" rather than spending less by equalizing down. Other areas where court decisions have imposed considerable costs on state budgets are prisons and correctional systems and mental health programs and institutions.

Notes:

1. *The Wall Street Journal*, Nov. 6, 1995, page A1.
2. *State Tax Notes*, March 20, 1995.
3. Telephone conversation with Peter Schaafsma, Apr. 23, 1996.
4. Terry Whitney, "School Finance Litigation Affects 16 States," *The Fiscal Letter*, (NCSL) 17, no. 3, (May/June 1995): 11.

2. State Efforts to Manage Budget Shortfalls

Because most states operate under a constitutional or statutory requirement for a balanced budget, they are required to resolve budget shortfalls and avoid potential deficits. Although their strategies vary, state officials usually:

- Impose short-term or stop-gap measures;
- Cut the budget;
- Increase revenues; or
- Implement some combination of these strategies.

Generally, the strategy depends on the following factors:

- *The amount of time remaining in the fiscal period.* The timing of a shortfall within a budget cycle affects the choices that can be made to resolve it. When a shortfall occurs late in a fiscal period, there are fewer options to address it because many strategies do not produce immediate results.
- *The severity of the shortfall.* Many strategies generate minimal revenues or produce modest budget savings. Although in combination they may add up to a sizable amount, they are unlikely to produce sufficient sums to resolve a severe budget shortfall.
- *Other actions that have been taken to eliminate recent shortfalls.* In some cases, such as when the national economy is in a recession, states may experience multi-year shortfalls. Some strategies, such as revenue accelerations, may be unavailable if they were used recently and not yet reversed.

An important consideration is whether the strategies are seen as temporary or permanent solutions. If a state is experiencing a short-term budget problem, temporary, one-time measures may be sufficient to address it. If the problem is longer term or produces a structural deficit, permanent adjustments may be necessary. Many of the strategies reviewed in this chapter have been used as short-term or temporary solutions when states have encountered budget problems. A number of policymakers, however, have made these adjustments permanent in an effort to control and better manage their states' finances. Chapters 4 and 5 contain greater detail on more permanent strategies to address budget problems.

Table 1 illustrates the strategies states used to manage budget shortfalls occurring in FY 1993, a year in which budget problems were widespread among the states.

Short-term or Stop-gap Measures

Short-term or stop-gap strategies generally have an immediate effect on a budget shortfall. They are not intended to deal with fundamental budget problems. They may depend upon one-time savings or revenues, and they may seem like treating a serious infection with a pain reliever—an expedient, not a cure. For these reasons, such measures may be viewed as gimmicks.

But there are valid reasons for policymakers to use short-term measures:

- State budget problems often result from the business cycle and may be short-term in nature. Overreaction can breed new problems.
- Although short-term measures (deferred maintenance or postponed contributions to employee pension funds, for example) can themselves result in new problems, these usually can be corrected after the budget crisis has passed.

Carefully applied, short-term measures are a corrective to the cyclical nature of state budgeting—they smooth the curves of revenue and expenditures between recessions and recoveries. Balanced budget requirements and limits or prohibitions on short-term debt make it almost impossible for most states to avoid a cyclical fiscal policy. They have to balance their budgets in recessions, even though revenues fall and demand for spending increases. Both expenditure cuts and tax increases are damaging to a recessionary economy, so short-term strategies that avoid them can be effective remedies.

Examples of short-term or stop-gap measures include:

- Delaying or eliminating capital expenditures and maintenance or shifting them from current funds to bond finance;
- Delaying pay to state employees or payments to vendors;
- Deferring tax refunds until the beginning of the next fiscal year;
- Eliminating sales tax vendor compensation fees;
- Reducing employee-related expenses, such as eliminating travel or imposing hiring freezes;
- Shifting money to the general fund from funds that are not needed immediately or that have surpluses;
- Tapping budget stabilization funds;
- Accelerating tax collections; and
- Postponing payments to or changing investment assumptions for state retirement systems.

Some short-term strategies would be irresponsible if they turned into permanent policies—delaying vendor payments, changing accounting methods, changing investment assumptions and tapping pension funds, for example. And some strategies produce one-time gains that have to be covered from some new revenue source in the future. Other strategies, such as tax accelerations, cannot be repeated unless they are reversed at some point (states often have reversed accelerations when prosperity returns). Delaying capital expenditures or maintenance can increase future expenditures. Bond underwriters may take a dim view of any such practices and downgrade bond ratings as a result.

Table 1. Strategies Used to Address Budget Problems Occurring in FY 1993

Temporary Measures (number of states)	
• Delayed payments to vendors (4)	District of Columbia, Maine, Montana, Texas
• Postponed capital projects financed by the general fund (4)	Minnesota, Montana, Nevada, New Jersey
• Replaced appropriations for capital projects with borrowing (5)	California, Maryland, Massachusetts, Missouri, Texas
• Delayed equipment purchases (8)	California, District of Columbia, Kentucky, Louisiana, Massachusetts, Puerto Rico, Vermont, West Virginia
• Other (2)	Michigan, New Jersey
Budget Reductions	
• Imposed across-the-board cuts (17)	Alabama, Connecticut, Idaho, Kansas, Kentucky, Maryland, Montana, North Dakota, Nebraska, New Jersey, New Mexico, Nevada, Ohio, Oklahoma, South Carolina, Vermont, West Virginia
• Imposed selective cuts (19)	California, Colorado, District of Columbia, Florida, Georgia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Montana, Nebraska, New Jersey, New York, Oregon, Puerto Rico, Texas, Washington
• Eliminated programs (8)	Alaska, California, Illinois, Maryland, Nebraska, Oregon, Texas, Washington
• Reduced aid to local governments (9)	Alaska, California, Illinois, Maine, Maryland, Michigan, Nebraska, Ohio, Vermont
• Other (9)	California, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, New Jersey, Washington
State Employees	
• Implemented layoffs (10)	Alaska, District of Columbia, Illinois, Maryland, Minnesota, Nevada, New Jersey, Oklahoma, Oregon, Washington
• Implemented furloughs (2)	District of Columbia, New Jersey
• Imposed salary freeze (12)	Colorado, Georgia, Indiana, Maryland, Michigan, Minnesota, Missouri, New Jersey, Oklahoma, Oregon, Vermont, Washington
• Eliminated vacant positions (12)	District of Columbia, Illinois, Louisiana, Maine, Maryland, Minnesota, Missouri, New Jersey, Nevada, Oklahoma, Oregon, Wyoming
• Required employee contribution to fringe benefit costs (2)	California, Oregon
• Reduced employer contribution to state pension fund (8)	Alaska, California, Indiana, Minnesota, New Jersey, Oregon, Vermont, Washington
• Offered early retirement program (7)	California, Illinois, Michigan, Minnesota, New Jersey, Texas, Washington

Table 1, continued

Revenue Measures	
• Raised taxes (14)	Arkansas, California, Delaware, District of Columbia, Maryland, Massachusetts, Michigan, Montana, New York, New Mexico, Ohio, Oregon, Washington, Wyoming
• Raised fees (17)	Arkansas, California, Delaware, District of Columbia, Maryland, Massachusetts, Minnesota, Montana, Nebraska, New Mexico, Nevada, New Jersey, Oklahoma, Oregon, Vermont, Washington, Wyoming
• Accelerated tax collections (9)	Alabama, California, District of Columbia, Indiana, Montana, Nevada, New Jersey, Texas, Wyoming
• Transferred funds to the general fund (19)	Alaska, Arkansas, California, Colorado, District of Columbia, Illinois, Kentucky, Louisiana, Maine, Maryland, Michigan, Montana, Nebraska, Nevada, New Jersey, Oklahoma, Texas, Vermont, Washington
• Delayed transfers out of the general fund (4)	California, Colorado, Texas, Washington
• Other (8)	Alabama, California, Illinois, Minnesota, New Jersey, New Mexico, New York, Oregon

These strategies may have other drawbacks as well. Anticipated savings or revenues can be substantially less than expected. There also has been a tendency to overestimate the value of these types of strategies in general, which leads to the inclusion of hidden deficits in a state's budget. As a result, legislators must be wary of the risks that accompany their budget strategies.

Cutting the Budget

As shown in table 2, cutting the budget is a common method used to eliminate a budget shortfall. The nature and extent of the reductions will vary depending on the size of the shortfall and whether other strategies, such as raising revenues, are used.

Cutting the budget to address a shortfall is an attractive option because the effect is immediate: the level of state spending is adjusted to fall within estimated available revenues by the end of the fiscal year. Depending on the size and scope of the cuts, the reductions can produce significant savings. There also may be political benefits if constituents perceive the government as holding the line on spending and avoiding tax increases.

Budget cuts provide policymakers with an opportunity to take a serious look at spending priorities. When revenues are plentiful, programs may continue without careful scrutiny. Re-prioritization and reallocation are more likely to occur when revenues are scarce. Further, budget cuts may force agencies to rethink whether they are providing services in the most efficient manner.

Cutting the budget has drawbacks as well. Government services may be disrupted, and legislative priorities may be undermined. If the cuts come late in a fiscal year, agencies may have a difficult time implementing the cuts. And finally, the cuts likely will have more adverse effects on small agencies because larger agencies may have more ability to absorb the cuts.

In fact, there is a broad perception that government agencies can easily absorb some level of budget cuts. This may be true if an agency has, say, substantial salary savings or caseloads that do not materialize. Overall, however, budget cuts can be disruptive to the provision of services, especially if agencies have to absorb a series of small cuts year after year. In some instances, it may be preferable to make permanent funding and responsibility changes to save an agency from operating under constant budget uncertainty.

Table 2. States Cutting the Enacted Budget: FY 1989 - FY 1995

Fiscal Year	Number of States	Total Amount of Cuts ($ millions)	Percent of State Budgets
1989	13	$ 922.5	0.4%
1990	21	2,756.0	1.0
1991	29	7,558.4	2.6
1992	35	4,457.8	1.5
1993	22	1,836.4	0.6
1994	10	871.7	0.3
1995	8	442.4	0.1

Source: National Association of State Budget Officers, *Fiscal Survey of the States*, various years.

Before implementing cuts, some states have imposed budget set-asides or holdbacks—requirements that a certain proportion of agencies' appropriations cannot be spent without special approval. In FY 1996, for example, New Jersey's governor imposed an 8 percent holdback for all agencies except corrections expecting that some agencies would end up spending only 92 percent of their original appropriation. This would help the state out of a tight budget situation. Such holdbacks anticipate that revenues will be insufficient to cover appropriations so, as a precaution, agencies are required to operate at reduced spending levels.

With a severe budget shortfall, however, budget cuts are probable. To mitigate the adverse effects, policymakers often turn to selective cuts before imposing across-the-board cuts. Selective cuts have the advantage of preserving the budgets of high-priority agencies or programs while targeting lower priority or nonessential agencies for budget reductions. States usually try to protect funding for elementary-secondary education, Medicaid and corrections when budget cuts become necessary. Even when across-the-board cuts do become necessary, these areas may be exempt or subject to smaller cuts than other agencies or programs. When cutting budgets, policymakers also have eliminated programs, consolidated functions and eliminated certain boards and commissions.

Three budget areas that have seen sizable budget reductions when states have encountered budget problems are higher education, state employees and local government.

Higher education. Higher education funding has been a frequent casualty of state fiscal problems because it does not have the immediacy of public safety/corrections or the funding match requirements of Medicaid. It also has an alternative source of funding: tuition and fees. Higher education funding is discussed further in chapter 4.

State employees. Because employee salaries and benefits account for a significant portion of state budgets, state employees may be targeted when budget shortfalls are imminent. Permanently reducing the size of the state work force has the most potential to substantially reduce employee-related expenditures and is discussed further in chapter 5. Other methods states have used to reduce employee costs include eliminating vacant positions, offering early retirement programs, instituting furloughs, decreasing the state's contributions to employee benefits such as health care and pensions, freezing or reducing salaries, delaying salary increases, limiting or restricting hiring and allowing voluntary unpaid leave.

Local government. State aid to local governments, including aid for education, accounts for approximately 30 percent of total state spending. As a result, states often have targeted local aid for cuts when budget shortfalls have loomed. Despite the potential for large

monetary savings, opponents of such action point out that reducing state aid merely shifts fiscal stress to local governments, unless the state provides some other assistance such as allowing local option taxes. Aid to local governments is discussed further in chapter 5.

Raising Revenues

Whether or not policymakers cut the budget, they may choose to raise revenues to deal with budget shortfalls. Revenues can be increased by freeing up existing revenues or by generating new ones. These increased revenues may be one-time in nature (e.g., revenue from tax amnesty programs) or long term (e.g., a permanent increase in the sales tax rate). Policymakers have raised revenues by:

- Removing earmarking provisions from certain taxes;
- Reducing tax allocations to local governments;
- Authorizing tax amnesty programs;
- Raising or imposing fees (e.g., environmental taxes and fees, license fees);
- Increasing excise taxes (e.g., alcoholic beverage tax, cigarette tax, motor fuel tax);
- Extending temporary taxes scheduled to expire;
- Imposing health care provider taxes;
- Broadening the bases of major taxes (e.g., personal income tax, sales and use tax);
- Increasing tax rates (e.g., personal income tax, sales and use tax);
- Implementing a new tax (e.g., tax on soft drinks); and
- Issuing short-term or long-term debt (unavailable in most states).

As policymakers can attest, the choice of revenue-raising options is not as simple as picking from a menu, but must take into account political and economic considerations. For example: What are current tax rates and levels? How is the tax burden distributed between individuals and business? How would these tax increases affect the state's business climate and tax competitiveness? What kind of opposition will the tax generate? What federal provisions, if any, affect this tax? Will the action raise sufficient revenue to address the budget problem? The list is practically endless and raises many concerns. Further, as some opponents of tax increases point out, raising revenues to deal with budget problems assumes that states should continue to provide current levels of service. They note that this assumption should be evaluated, especially for longer-term budget problems. (To see the kinds of revenue-raising actions states have taken in the past decade, see NCSL's series of reports, *State Tax Actions*.)

Restrictions on Certain Deficit Reduction Actions

States may be limited in how they can respond to budget problems. Legal obligations and constitutional provisions may make some options unavailable. For example, collective bargaining agreements will limit budget reduction strategies affecting state employees. Constitutional restrictions against issuing short-term debt for ongoing operations make that option illegal for most states. But states also may be limited by practical considerations such as public sentiment and the need to provide a certain level of services. The antitax movement is strong in many states, so raising taxes may be a limited option in those states. And, finally citizens place a high priority on certain services, such as elementary-secondary education and public safety, so they would be strongly opposed to severe cuts in those areas.

3. State Methods to Avoid or Minimize Budget Shortfalls

This chapter reviews several techniques for avoiding or minimizing budget shortfalls:

- Limiting appropriations to a percentage of estimated revenues;
- Imposing contingency budget reductions and trigger mechanisms; and
- Creating and adequately funding budget stabilization funds.

Limiting Appropriations to a Percentage of Estimated Revenues

Five states limit appropriations to avert budget shortfalls due to the unpredictability of revenue. These five states—Delaware, Iowa, Mississippi, Oklahoma and Rhode Island—limit appropriations to a set percentage of the official general fund revenue forecast; the limits exclude appropriations of federal funds. Although two of the measures date back to the 1980s, three were implemented in 1992—just as states were beginning to recover from the fiscal problems of the early 1990s. Three of the provisions are constitutional, and two are statutory. As shown in table 3, the limits range from 95 percent in Oklahoma to 99 percent in Iowa.

The primary goals of the measures are to improve cash management and enhance overall stability. The limits almost ensure a balanced budget. If revenue collections match or exceed the estimate, the process generates a reserve that can be used as a financial cushion against future problems. Some states also consider the limit a fiscal discipline tool.

Table 3. States That Limit Appropriations To a Percentage of Estimated Revenues

State	Year Enacted/ Approved	Authorization	Amount of Estimated Revenues Available For Appropriation
Delaware	1980	Constitutional (Art. VIII, §6)	98%
Iowa	1992	Statutory	99%
Mississippi	1992	Statutory	98%
Oklahoma	1985	Constitutional (Art. 10, §23)	95%
Rhode Island	1992	Constitutional (Art. 9, §16)	98%

Source: NCSL Summary of State Statutes and Constitutions, 1995

The measures are similar in design and function. Each of the five states links its provision to its budget stabilization fund. There are some differences, however.

Delaware. Delaware's provision, the first one implemented, allows any general fund revenues in excess of the 98 percent limit to be appropriated in the event of an

emergency. The appropriation must be approved, however, by three-fifths of the members elected to each house of the General Assembly. If the funds are not appropriated for an emergency, they must be deposited in the state's budget stabilization fund (the Budget Reserve Account) and are subject to the provisions governing that fund.

Iowa. State statutes require the governor to use the appropriations limit when preparing the budget and the General Assembly to use it in the budget process. The limit is 99 percent of the adjusted revenue estimate, except that the limit is reduced to 95 percent for any new revenue source for the first year that the new revenue source is in place. New revenues refer to money received from new or increased taxes and fees. Any revenues in excess of the appropriations limit flow to the state's budget stabilization fund (Cash Reserve Fund). Once that fund's cap is reached, the money goes to an emergency fund (Economic Emergency Fund).

Mississippi. As part of budget reform in 1992, Mississippi implemented its 98 percent limit on legislative appropriations from the general fund. The limit began with the appropriations for FY 1994. Any collections above 98 percent of the revenue estimate are considered lapsed funds and remain in the general fund until the end of the fiscal year. At that time, half of the general fund ending balance becomes available for appropriation, and the other half is transferred to the budget stabilization fund (Working Cash-Stabilization Reserve Fund). Once that fund has reached its cap, the extra money is deposited in a special fund for education.

Oklahoma. The Oklahoma Legislature is constitutionally limited to appropriating no more than 95 percent of the official state revenue forecast. Between 35 and 45 days before the Legislature's regular session convenes, the State Board of Equalization certifies revenue projections for the coming year and calculates the 95 percent amount. If the other 5 percent of the estimate is collected, it stays in the general fund as a reserve until the fiscal year is over and then becomes available for appropriation. Any revenue that comes in above 100 percent of the official forecast is deposited in the state's budget stabilization fund (Constitutional Reserve Fund) and is subject to the provisions governing that fund.

Rhode Island. Approved in a statewide referendum in 1992, Rhode Island's provision limits general fund appropriations to 98 percent of estimated general fund revenues. Any revenues between 98 percent and 100 percent must be appropriated to the budget stabilization fund (Budget Reserve Account), provided that the deposit does not cause the fund to exceed its cap. If the cap is met, the extra money must be used for reducing state indebtedness, paying debt service or funding capital projects.

Although the provisions in these five states are intended in part to impose fiscal discipline, they do not necessarily limit expenditure growth. If, for instance, revenues are growing at a healthy pace, state spending is also being allowed to grow, although not as much as revenue. Taxes also may be increased or money may be transferred from other funds to supplement general fund resources. Such actions can allow state spending to grow within the constraints of the appropriations limit.

Furthermore, these limits do not guarantee that a state will avoid a budget shortfall. If actual revenues are substantially below projections, spending could exceed revenue collections, leading to a budget gap. Once again, the unpredictability of state revenues emerges as a major contributor to budget problems. Another drawback is that revenue estimators may consciously or unconsciously make higher projections because they know that only a percentage of the estimate will be appropriated.

In addition to the five states that limit appropriations to a percentage of the official general fund revenue forecast, several states have taken other steps to ensure minimum ending balances in their general funds. For example, a Kansas statute enacted in 1990 and modified in 1994 requires a targeted year-end balance for the state's general fund. The minimum balance prescribed by law was 5 percent of total authorized expenditures in FY 1992 and was increased each year to reach 7.5 percent by FY 1995. In Wisconsin, a law enacted in 1977 and modified several times requires an annual year-end general fund balance of no less than 1 percent of general fund expenditures.

Contingency Budget Reductions and Trigger Mechanisms

Another method states have adopted to address fiscal uncertainties is contingency budgeting. A contingency plan anticipates events and the necessary actions to be taken to produce a specific outcome. For example, an event (a revenue shortfall) triggers an action (budget cuts) to produce a desired outcome (a balanced budget). Most states use some form of contingency planning to address budget problems because the other common option—calling a special legislative session to readdress the budget—can be costly and time-consuming. The contingency plans in most states grant the governor some authority to reduce appropriations when the state encounters unanticipated budget problems. In many instances, the governor's authority is limited to specific actions, or the legislature must approve the actions. (For more information on this topic, see *Legislative Authority Over the Enacted Budget.*)

Despite the time- and cost-saving elements of contingency budgeting, it has important drawbacks. Most notably, contingency provisions by their nature may provide the executive branch with more budget decision making and control than most legislators prefer. Further, large shortfalls may require extensive cuts that, when imposed by the governor, dramatically change legislative spending priorities. To prevent this from happening, legislators may actually prefer convening in a special session.

Because most governors have authority to cut the budget to address budget problems, few states design the budget with contingency budget reductions built into the process. Arkansas and Kentucky are exceptions. In Arkansas, contingency budgeting requires that agencies prioritize their spending so that reductions are predetermined if revenues do not materialize as projected. In Kentucky, the legislature enacts budget reduction and surplus expenditure plans each year that establish the legislature's spending priorities in the event that either a revenue shortfall or a surplus develops. On a less regular basis, states may adopt special contingency plans or trigger mechanisms if budget problems appear to be a strong possibility.

Arkansas and California present two different models of how states can apply contingency or trigger mechanisms to the budget process to mitigate revenue shortfalls.

Case Study: Contingency Budgeting In Arkansas

The Revenue Stabilization Law, enacted in Arkansas in 1945, has two primary goals: (1) to ensure that the state lives within its resources and (2) to allow the governor and legislature flexibility to set funding priorities every two years. The law, which applies to the general fund, includes several provisions to accomplish these goals, including:

- The creation of a mechanism for legislative priority-setting every two years that would be stable regardless of the performance of state tax collections; and

- The development of a system that allows state agencies to make budgetary decisions consistent with revenue collections by having the ability to easily determine the level of funding that would be available.

Under the Revenue Stabilization Law, appropriations are tied directly to revenue collections and there is a spending plan in place for every dollar of the forecast. But the law takes into account that it is difficult to estimate revenues accurately. To keep spending within actual revenue amounts, the law requires that appropriations be made according to priority categories that are established by the legislature every two years. Usually the legislature establishes three priority categories—A, B and C—although there have been up to five levels in the past—A, A1, B, B1 and C. All commitments in the A category must be funded before the next level receives any funding, then once the second level is completely funded, the next level will receive funding and so on until revenues are exhausted or all priority categories are funded.

Although the legislature does not classify agency programs as A, B or C, it provides specific appropriated amounts to each of these categories. Appropriations made by the legislature are maximum authorizations. The legislature determines each agency's funding level in each category based on revenue estimates. Once the department has been notified of its appropriation, it prioritizes its programs into the various category levels. Typically, category A has a 98 percent chance of being funded, category B has about a 50 percent chance and category C has less than a 20 percent chance.

To summarize, the process basically follows these steps:

- The number of categories (e.g., A, A1, B, C) are determined by the legislature.
- The Joint Budget Committee determines the total appropriation funding for each of the categories based on revenue estimates.
- The Joint Budget Committee determines the portion of each agency's appropriation funding that is assigned to each category.
- The agencies prioritize programs and place them in the categories.

The law permits the legislature to set priorities on new appropriations, yet leaves it to the agencies' discretion as to how they wish to prioritize programs. Essential programs are usually funded, but new programs or enhancements may not receive funding. If an agency ends the year with unspent appropriations, the funds usually return to the general revenue pool and are used to fund state construction projects. However, some departments, like schools, retain savings accrued during the year.

In addition to the benefits and drawbacks of contingency budgeting identified earlier, Arkansas' version has other distinct pros and cons. Some advantages are:

- It forces program evaluation by requiring agencies to prioritize their spending.
- It protects minimum program needs and eliminates optional program enhancements when funds become limited.
- It minimizes uncertainty for agencies during the fiscal year because managers know which areas of their budgets will be cut if the state faces a revenue shortfall.

Some disadvantages are:

- Agencies assume a critical role in establishing spending priorities, a responsibility reserved for the legislature in many other states.
- Legislative initiatives may not get funded at all because they depend on where the agency places them in the budget.

- Before budget problems even develop, policymakers and agency managers are required to establish and communicate that some programs are not high priorities—a process that may produce unnecessary distress if revenues materialize as projected.

State officials describe Arkansas' contingency budgeting as a complex process that is difficult to understand. Even so, it is likely to remain because it is credited for Arkansas' ability to maintain a stable budget with no deficit spending.[1]

Case Study: Trigger Legislation in California

As the 1990s began in California, so did a new era of financial hardship and budget deficits. In response, the legislature adopted a two-year plan in 1994 to eliminate the state's budget deficit by the end of the 1995-96 fiscal year. The financing of that plan included the sale of revenue anticipation warrants—short-term bonds that will be repaid from the state's future revenue collections. To ensure that the state would be able to meet its debt repayment obligations, the legislature enacted Chapter 135/94 (SB 1230)—known as "trigger legislation."

The legislation established a fiscal monitoring and adjustment process designed to guarantee that the state would have sufficient cash to repay the revenue anticipation warrants. Projection of a certain level of budget shortfall would "trigger" action to mitigate the shortfall. With the input of the legislative analyst (a legislative fiscal officer), the state controller was required:

- To determine on Nov. 15, 1994, whether the general fund's anticipated year-end cash position had worsened by more than an acceptable amount; and
- To determine on Oct. 15, 1995, whether available cash projected for the end of 1995-96 would fall short of the amount needed to repay external borrowing.

If the state controller determined that a shortfall of sufficient size was projected, the legislation directed the governor to propose new legislation that would provide for general fund expenditure reductions, revenue increases or both to offset the amount of the estimated 1995 or 1996 cash shortfalls. If legislation was not passed by Feb. 15 of the fiscal year, the director of finance would apply automatic across-the-board spending cuts to all general fund programs, except those protected by federal law or the state constitution (primarily K-14 school funding).

The trigger legislation required the legislative analyst to assist the state controller by providing an analysis of general fund revenues and expenditures and to review the state controller's estimate of the state's cash position within five working days of the determination. Under the trigger law, the state's cash position was measured by the estimated amount of "unused borrowable resources" remaining available to the general fund on June 30 of the fiscal year. Unused borrowable resources referred to total available borrowable resources on that date, less total cumulative loan balances on that date.

Borrowable resources consisted of internal borrowable resources (cash balances in special funds that the general fund may legally borrow) and external borrowable resources (such as the proceeds from the sale of revenue anticipation notes and warrants). The amount of unused borrowable resources is the difference between total borrowable resources and the amount of these resources that already has been borrowed by the general fund to finance its cash needs.

As it turned out, the trigger was not pulled in 1994-95 because on June 30, 1995, the state controller projected a $581 million improvement in California's general fund, and the legislative analyst agreed that the controller's estimate of the state's cash position was reasonable. This put the state well above the cash position that would have set off the trigger. Budget improvements in fiscal year 1995-96 also prevented the trigger from being pulled.

Budget Stabilization Funds

Budget stabilization funds, or rainy day funds, are arguably the most common tool states have developed to address budget shortfalls. By 1996, 45 states and Puerto Rico had created a total of 52 funds. The only jurisdictions not implementing stabilization funds are Arkansas, the District of Columbia, Hawaii, Illinois, Montana and Oregon. (For detail on state rainy day funds, see "States Broaden Scope of Budget Stabilization Funds.")

The original concept of a budget stabilization fund is straightforward: Money is saved when state finances are healthy for use when the state's economy takes a downturn. Although the concept is simple, not everyone approves of it.

On the positive side, a rainy day fund:

- Promotes budget stability by allowing state officials to avoid ad hoc budget cuts or tax increases to avoid a budget shortfall;
- Buys time for state officials to make better informed decisions about longer-term solutions to budget problems so that decisions are not made in a crisis atmosphere;
- Serves as the repository of excess revenues, thereby reducing the use of one-time revenues to fund ongoing expenditures;
- Weighs in the state's favor with bond-rating agencies.

On the negative side, a rainy day fund:

- Contains excess revenues that should be returned to taxpayers;
- Serves as a temporary crutch to address budget problems, thereby delaying permanent solutions such as budget cuts or tax increases;
- Serves as a tempting source of revenue to fund a variety of state programs before a shortfall occurs and therefore may be used to fund ongoing expenditures;
- May be inaccessible if bond-rating agencies threaten to lower the state's bond rating if any or all of the fund is touched.

As a rule, budget stabilization funds contain insufficient money to really be useful when states face economic downturns. Although Wall Street analysts recommend that states maintain budget reserves equal to 3 percent to 5 percent of their general fund budgets, most states typically fall far below that level. At the end of FY 1995, for example, only 10 funds met or exceeded the recommended level. Nine states had funds with a zero balance, and five had balances equal to 1 percent or less of FY 1995 general fund appropriations.[2]

Although most states have low or modest fund balances, more than half have imposed limits on the fund's maximum size. In 13 states, the cap is 5 percent (of general fund appropriations, expenditures, prior year revenues or some other similar base). Half a dozen states have 10 percent caps. Other caps range from 2 percent in New York to 25 percent in Michigan. Two states cap the fund at a specified dollar amount: $75 million in Alabama

and $100 million in Nevada. With a few exceptions, the balances in most budget stabilization funds have not reached their legal caps.

The most important criterion for an effective rainy day fund is its size. Several factors affect fund size:

- Whether the fund is statutory or constitutional;
- The type of deposit mechanism;
- The type of withdrawal mechanism; and
- Limitations on the use of the fund.

These criteria are discussed further in Eckl, "States Broaden Scope of Budget Stabilization Funds."

Several states have modified their budget stabilization funds in recent years, placing particular attention on how money is deposited to and withdrawn from the stabilization funds. These ongoing changes illustrate that some state policymakers recognize the limitations of their current funds and are attempting to improve them. With such efforts under way, stabilization funds may become more effective tools in the future to help states avoid or minimize budget shortfalls.

Case Study: Indiana's Counter-Cyclical Revenue and Economic Stabilization Fund

Indiana's Counter-Cyclical Revenue and Economic Stabilization Fund, now commonly known as the rainy day fund, was established in 1982. Deposits to and withdrawals from the fund are based on a statutory formula. The basic concept of the formula is as follows: (1) For deposits, the fund receives any general fund revenue resulting from real (inflation-adjusted) growth in state personal income (minus transfer payments) of more than 2 percent a year and (2) for withdrawals, there must be a decline in personal income of more than 2 percent in a year. The legislature can override the formula with a majority vote.

The deposit mechanism was first triggered in 1985 and resulted in a $145.1 million deposit. Since that time, growth in real personal income has resulted in four additional deposits. Although economic conditions in Indiana have not triggered a withdrawal, the legislature overrode the trigger mechanism to access the fund in the early 1990s. In FY 1991, most of the fund's interest earnings were transferred to the general fund, in part to address budget problems but also to keep the rainy day fund balance from exceeding its 7 percent cap. In FY 1992 and FY 1993, transfers were made from the fund to help balance the general fund budget.

Although there is a limited amount of evaluative information and analysis available on Indiana's rainy day fund, state observers report that the fund has worked effectively: the deposit trigger works well and ample funds have been available to address short-term budget problems. On the downside, the withdrawal trigger is viewed as being too stringent. For the trigger to take effect, the state would have to be in such serious fiscal trouble that the fund's balance would be insufficient to make a significant difference.

As previously noted, the fund balance is capped at 7 percent (of a portion of state general fund revenues). There is some concern that this cap may be too low; some argue a 10 percent cap may be preferable if the objective of the fund is to avoid tax

increases when state finances take a downturn. In Indiana's case, the current 7 percent cap is not based on total general fund revenues: In addition to general fund revenues of about $5.9 billion in FY 1995, approximately $1.5 billion of state revenues is allocated to the Property Tax Replacement Fund and the Property Tax Relief Fund. If the cap was based on total state operating revenues, the balance could be much higher.

Case Study: Pennsylvania's Tax Stabilization Reserve Fund

Pennsylvania's Tax Stabilization Reserve Fund was created in 1985. Although the fund is capped at 3 percent of general fund revenue estimates, it peaked at 1 percent of revenue estimates in 1991. Before 1991, the fund required appropriations from the legislature for its funding, but a change was made that year allowing for the automatic deposit of 10 percent of any surplus revenues at the end of a fiscal year. Appropriations can still be made to the rainy day fund.

Withdrawal requires a two-thirds vote of the legislature when the governor declares an emergency or to counterbalance downturns in the economy that will result in a significant unanticipated revenue shortfall. The entire reserve, $138 million, was tapped in 1991 to deal with a downturn in the economy and falling state revenues. This is the only time that a withdrawal has been made from the reserve fund.

Because of the small balance in the fund and the magnitude of the state's fiscal problems, the fund was a minor factor in resolving the state's budget crisis in the early 1990s. In fact, the state ended up enacting a $3.2 billion tax increase and imposing budget cuts. But advocates of the fund indicate that it served a valuable purpose: Its availability and use bought the legislature time as it was debating an emergency tax increase package. According to some officials, this enabled state policymakers to make better informed decisions.

Part of the problem in fully funding the Tax Stabilization Reserve Fund is said to be political opposition to the existence of such a fund. Critics of the reserve fund believe that any surplus revenues that the state collects should be returned to the taxpayers. This argument was part of the debate at the inception of the reserve fund and is still a factor today. Critics also claim that simple across-the-board cuts in state spending during economic downturns can save more money than is available in the reserve fund.

Supporters of the reserve fund believe that it can be a useful budgeting tool if kept near its 3 percent cap. Advocates also argue that more deliberate actions should be taken to fully fund the reserve.

Notes:

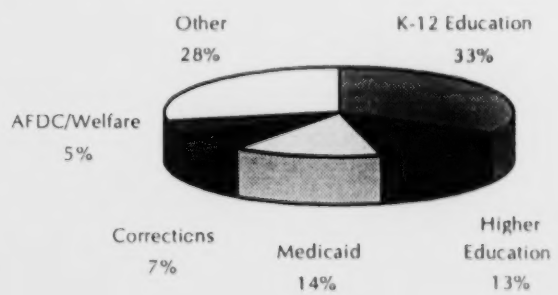
1. Telephone conversation with Bill Goodman, Assistant Director of Research and Tax in the Arkansas Bureau of Legislative Research.
2. *State Budget Actions 1995*, NCSL.

4. Options to Reduce State Spending in Major Program Areas

Chapter 3 reviews strategies states have used to address short-term budget shortfalls. Not all budget shortfalls, however, are due to unanticipated, short-term factors like court decisions, recessions or inaccurate revenue estimates. Some states face perennial budget shortfalls when the rate of growth of major expenditure programs exceeds the rate of growth of revenues necessary to fund them. This type of imbalance is commonly called a "structural deficit." Short-term measures like those described in chapter 3 may help states temporarily avoid shortfalls, but generally they are ill-suited to address structural deficits.

This chapter identifies the major spending categories in state budgets. It discusses state strategies to reduce spending growth in these programs and provides several short case studies that illustrate these strategies and discuss their effectiveness. The other factor contributing to structural deficits—the nature of state revenue systems—is addressed in NCSL's publication *Financing State Government in the 1990s.*

Figure 2. Components of State General Fund Spending, FY 1995



Source: National Association of State Budget Officers, *1995 State Expenditure Report,* April 1996.

Key Sources of State Spending

Figure 2 provides a breakdown of the major functional categories of state spending in fiscal year (FY) 1995.

The five largest functional categories of state general fund spending are elementary-secondary (K-12) education, Medicaid, higher education, corrections, and Aid to Families with Dependent Children (AFDC) and welfare. In combination, these programs received more than 70 percent of general fund expenditures in FY 1995. With the exception of AFDC, the share of state spending on these programs has been slowly growing for years. All other programs—including general purpose local aid, environmental protection, economic development, employment and training and many others—made up the remaining 28 percent of general fund spending. This chapter focuses on reducing expenditures in the five general fund programs listed above.

K-12 Education

Over the last 25 years, states have significantly increased their commitment to funding K-12 education. State funding has grown in real terms as a result of legislative efforts to improve the quality of education, growth in student enrollment in some states, court decisions requiring states to equalize spending between poor and rich districts, the increased cost of federally mandated special education programs and legislative or citizen initiatives to reduce the local property tax burden. K-12 education represented 33.8 percent of state general fund spending in FY 1995 (figure 2).

As noted in chapter 2, states usually try to preserve funding for K-12 education when shortfalls occur. Nevertheless, there are several options for reducing school funding, including across-the-board cuts in general state aid programs, reducing the foundation funding amount, reducing or eliminating minimum aid amounts or reducing categorical aid programs for such items as transportation, special education and capital outlay.

Across-the-board cuts. Across-the-board cuts are sometimes used to address midyear budget shortfalls. They provide immediate and certain savings to the state budget because aid disbursement amounts are under the direct control of the state. Across-the-board cuts treat all school districts that receive state aid equally and generally do not undermine the redistributive effects of school finance formulas. However, school districts have little flexibility to reduce planned expenditures during a fiscal year because personnel costs are a large proportion of school spending.

Reducing the foundation amount. Forty of the 50 states use a foundation school aid formula.[1] The foundation amount—set by the legislature—is the amount of per pupil funding that is required to provide a minimum level of educational services. The state provides local districts with the difference between the foundation amount and the amount of local funds that can be raised with a local property tax rate determined by the legislature. Reducing the foundation amount reduces the amount of per pupil state aid required under the formula. It may also increase the number of districts that do not receive state aid because they can raise more than the foundation amount through their own local property tax base.

Relatively small reductions in the foundation amount can create significant savings in state education spending. They also ensure that the bulk of state formula aid continues to flow to the poorest districts. However, reductions in foundation support may increase property taxes for taxpayers in districts that receive little or no state aid, eroding political support for state aid from legislators in those districts. Also, reducing the foundation amount may harm efforts to equalize spending between rich and poor districts by reducing per pupil spending in poor districts.

Case Study: K-12 Foundation Aid Reductions in Vermont

Vermont introduced its school foundation formula in FY 1988 with $112 million. Using large state surpluses, it increased funding dramatically to $148 million by FY 1991. But like many other states in the early 1990s, Vermont began experiencing fiscal problems. Consequently, funding for the foundation formula was cut to $140 million in FY 1993 and stayed at this level through FY 1996. The state achieved level funding for the foundation program by increasing the required local property tax rate used in the formula from $1.15 per $100 of assessed property value in FY 1993 to $1.31 per $100 of assessed property value in FY 1996. As a result, the local property

tax share of education funding increased from 62 percent in FY 1988 to almost 70 percent in FY 1996.

Resident property tax burdens in Vermont are now among the highest in the nation. Because level state funding of the foundation program has increased the education property tax burden statewide, voters have defeated dozens of proposed increases in local school budgets. Heavy reliance on local property taxes to fund education also has exacerbated disparities in per-pupil spending between property-rich and property-poor districts, spawning a constitutional challenge to the legality of Vermont's school finance system.

Increasing the local property tax rate used in the foundation formula also increased the number of school districts that receive no state aid. In Vermont, the number of "out of formula" districts increased from 44 to 50 (out of 251 districts) between FY 1993 and FY 1996. Because 20 percent of the state's school districts have no investment in the state aid program, building political support for state aid to education is more difficult.

Reducing or eliminating minimum aid amounts. Some states provide minimum aid amounts to all school districts regardless of their fiscal capacity. The rationale for minimum aid is to ensure that all taxpayers who pay general fund taxes to support public education, even those in wealthy communities, receive some state educational support. Minimum aid formulas help build political support for school finance bills in the legislature, so eliminating minimum aid amounts may make consensus-building more difficult. However, reducing or eliminating minimum aid would ensure that reductions are targeted to those districts that can most afford to absorb them through additional local tax effort.

Reducing categorical aid. Categorical aid programs provide state aid for specific purposes such as transportation, teacher retirement, special education or capital construction. In most states, even the wealthiest school districts receive aid for these items. Proponents argue that categorical aid programs are designed to reflect special factors, such as high transportation costs in rural areas or high costs imposed by federal special education mandates.

Reducing categorical aid, particularly as an alternative to cuts in the general state aid program, would help protect most of the poorest school districts from aid reductions. However, reductions in categorical aid programs could disproportionately harm rural areas that receive transportation aid or small districts with a higher percentage of special needs students. This is particularly burdensome because by law schools cannot reduce services to those students.

Medicaid

Medicaid is a joint state-federal program that provides medical care for the poor and medical and institutional care for the eligible elderly and disabled. During the last five years, the growth rate of the Medicaid program has been higher than any other major area of state general fund budgets. Although individual states' experiences varied widely, nationally, Medicaid's share of state budgets grew from less than 10 percent in FY 1989 to 14.3 percent in FY 1995. States spent almost $59 billion on the Medicaid program in FY 1995.[2]

Federal rules limit states' ability to reduce Medicaid in several ways. First, because the federal government reimburses state expenditures at rates between 50 percent and 80 percent, state actions that reduce Medicaid spending return only a fraction of the savings to

the state budget. Second, federal rules require that states participating in Medicaid cover certain low-income, disabled and elderly populations. States that attempt to reduce or eliminate benefits to these individuals will be sued in federal court. Third, Medicaid rules limit states' ability to move beneficiaries into managed care. Although waivers are available, the waiver process can be time-consuming, and there is no guarantee of approval. Fourth, a federal law known as the Boren amendment limits options for reducing payments to providers because it requires states to make reasonable reimbursements to cover provider costs. Finally, states that have expanded coverage beyond federal minimum requirements may be subject to maintenance-of-effort requirements if they try later to eliminate optional groups.

In 1996, Congress approved proposals to loosen many restrictions on states' Medicaid programs. Although these proposals were vetoed by the president, it is possible that states—either through law changes or waivers—may have additional options to reduce Medicaid program costs in the coming years. The following discussion outlines options for states if existing restrictions are removed or if federal waivers are adopted that allow more state flexibility in the program. It is summarized from a 1995 report by the Urban Institute, "Cutting Medicaid Spending in Response to Budget Caps."

Medicaid is really two programs: an acute care program for eligible elderly, disabled and low-income Americans and a long-term care program for the eligible elderly and disabled. The first four options below relate to the acute care portion of Medicaid, and the subsequent four discuss potential savings in the long-term care portion. The last option discusses provider taxes.

Managed care. One option to reduce program costs is to move Medicaid recipients into managed care health plans, such as health maintenance organizations (HMOs). Almost every state has some type of Medicaid managed care plan. Many states have placed former AFDC-eligible beneficiaries and the expanded populations of children and pregnant women in managed care. Managed care plans require patients to see only physicians who are part of a plan's network. All patient services are coordinated through a primary care physician. In the 1990s, private sector businesses contracting with managed care plans have enjoyed significant savings over fee-for-service plans in many markets. However, because Medicaid provider payment rates are typically lower than private sector plans, the margin of savings for states is smaller than in the private sector. Also, it is not certain moving the most expensive Medicaid beneficiaries—people with disabilities and the elderly—into managed care plans will result in similar cost savings.

Case Study: Arizona's Managed Care Program

In 1982, Arizona became the last state in the union to enter the federal Medicaid system when it received a federal waiver to operate its managed care program—the Arizona Health Care Cost Containment System (AHCCCS). Under Section 1115 of the Social Security Act, the state is allowed to pursue Medicaid projects that test new and innovative ideas relating to benefits and services by waiving certain federal requirements. The AHCCCS program originally provided only limited Medicaid services, but it has since been expanded to include all Medicaid services that are required under federal law. The primary AHCCCS acute care program covers about 450,000 beneficiaries.

In 1989, the AHCCCS program initiated a managed care program for recipients of long-term care. This program offers acute care, nursing home care and home- and

community-based services to the elderly and disabled. The long-term care component of AHCCCS covers about 20,000 people.

Since its inception, AHCCCS has been a pure form of managed care that pays managed care organizations on a capitated basis. Capitation is a method of payment for health service in which a provider is paid a fixed amount over a specific period of time for each person enrolled, regardless of the number or nature of services provided. The state solicits bids from managed care organizations in each of its counties and awards contracts based on price and past performance.

The AHCCCS accumulated an impressive record of savings during its first decade of operation, spurring other states to study and in some cases borrow from the Arizona model. The annual per capita growth rate for program expenditures between 1983 and 1991 for the AFDC and Supplemental Security Income (SST) populations was 6.8 percent, compared with a national average of 9.9 percent for the traditional Medicaid program. More recent data continue to reflect favorably on the program. AHCCCS capitation rates—the amount that the program pays to managed care networks per beneficiary—fell by 11 percent between 1994 and 1995. The program cost 8 percent less than fee-for-service programs in a 1990 evaluation and 11.3 percent less in 1993.

Studies by the U.S. General Accounting Office show that the AHCCCS program has been very effective in controlling the growth of expenditures in the long-term care arena, particularly for the disabled population. Between 1987 and 1991, annual expenditures for SSI-eligible disabled beneficiaries grew by 5.4 percent annually versus an estimated 17.3 percent annual growth in a fee-for-service program. For aged beneficiaries under AHCCCS, annual costs grew by an average of 9.5 percent compared with a 17.2 percent growth rate under the fee-for-service benchmark.

GAO and other studies of the Arizona program cite competition among a large number of managed care organizations as a key factor in controlling the cost of AHCCCS. Another factor contributing to the success of the program is the federal waiver that allows managed care organizations to serve only Medicaid clients, instead of following federal requirements that 25 percent or more of a managed care organization's clients be non-Medicaid. Evaluations also show that AHCCCS cost reductions have not harmed access to appropriate care and that Arizona's managed care system has been successful in both urban and rural areas.

Provider payment reductions. Another cost-saving option is to reduce payments to physicians, hospitals and other providers that treat Medicaid patients. Market conditions (the need to reimburse providers adequately) and the federal Boren amendment (which requires that state reimbursements cover reasonable provider costs) limit states' freedom to act in this area. Nonetheless, reductions in provider rates have been a common strategy to control Medicaid costs. In FY 1994, 12 states cut provider rates for certain services, and five others froze them at current levels. Nursing homes and home health care providers were particularly likely to be targets of these practices. In 1995, nine additional states imposed reductions in reimbursements on health providers. Such reductions may raise concerns about the maintenance of quality care.

Details on state policy on provider payments appear in NCSL's *Medicaid Survival Kit*, designed to help legislators understand existing Medicaid policies.[3]

Case Study: Provider Reimbursement Reductions in West Virginia

The level of state Medicaid expenditures, the prospect that changes in federal policy would cut federal aid to the state and elimination of certain financing techniques led West Virginia's governor to convene a Medicaid Crisis Panel in July 1995 to recommend ways to reduce Medicaid expenses. Legislators and state officials participated in the deliberations and produced recommendations designed to cut total state Medicaid spending. Estimated savings for FY 1996, when some of the policies went into effect, were $52 million. The complete range of changes is expected to reduce total state Medicaid spending by $141 million in FY 1997, or approximately 10 percent.

Such significant reductions pose questions about the preservation of quality. The West Virginia Medicaid Crisis Panel made it clear in its analysis, *Report and Recommendations,* that quality care was as much a concern as cost reduction: "The panel's recommendations do not constitute and should not be taken as an endorsement of expenditure reductions in the Medicaid program as a matter of policy," but are meant as a balance between the "human and the budgetary aspects of the Medicaid program."

Most of the estimated $141 million in savings will come from reductions in provider payments. The most important single step has been a change to "prospective rate setting methodology," a technique by which a state pays a provider a specified amount for the coming year, and the provider must control costs within the amount. The technique forces economies on the provider, since Medicaid providers may not refuse treatment to Medicaid patients (although physicians may drop out of the program and thus not accept Medicaid patients). This is different from capitation because the payment is not adjusted for caseloads.

Other policies are intended to remove incentives to providers to treat clients as in-patients. These changes include reduced reimbursements for inpatient psychiatric treatment, reduced occupancy incentives in nursing homes and reduced reimbursements for what the panel saw as nonhealth-centered programs under the state Medicaid umbrella. And the panel recommended substantial reductions in the reimbursement for some specific services, such as lab work, x-rays, medical equipment and surgical centers.

The panel pointed out in its final report that its recommendations provide intermediate remedies and that systemwide reform would be required to create the proper incentives for provider and user behavior and to make Medicaid truly cost-effective. It noted particularly the inflexibility of the federal-state Medicaid partnership, with the clear implication that giving a state the flexibility to redesign its Medicaid services would prevent the need for make-do policies such as reducing provider rates.

Reductions in optional services and programs. The Medicaid program encourages, but does not require, states to provide a series of optional services such as prescription drugs and vision care. States also have the option to expand coverage to low-income families above the mandated levels for children and pregnant women. States could scale back to the mandatory income thresholds or cut back on coverage of optional services. Such reductions could save up to 10 percent of program costs, according to the Urban Institute study. However, current law includes maintenance-of-effort requirements that impose severe financial penalties on states that curtail eligibility for optional groups. A federal law

change that would allow states to reduce the optional populations covered could provide savings for states with high-cost programs.

Welfare program changes. Because people who qualify for Supplemental Security Income and the former AFDC program automatically are eligible for Medicaid, reducing the number of qualifying welfare recipients could reduce Medicaid costs. In 1996, a new law that eliminated eligibility for people who qualified for SSI based on drug or alcohol addiction should reduce Medicaid caseloads. However, the new federal law change and other welfare changes that reduce Medicaid eligibility could lead to more uncompensated care in hospital emergency rooms. Unlike the Medicaid program, these expenses may not be eligible for federal matching funds.

Reductions in nursing home payments. Reductions in reimbursements to nursing homes could provide immediate cost savings to state budgets, assuming that states could withstand Boren amendment challenges or that the Boren amendment restrictions would be lifted by Congress. However, many nursing homes are almost completely dependent upon Medicaid revenues, so reimbursement reductions could increase patient-to-staff ratios and raise other quality of care issues. Also, Medicaid nursing home payments are typically low already, so the margin for savings may be small.

Nursing home beds restrictions. This would require the development of community-based alternatives such as group homes for those recipients who do not require higher levels of care. Program costs would be reduced by delaying or eliminating altogether the need for nursing home care for some of the elderly. Bed restrictions are unlikely to provide immediate budget savings but may provide long-term savings.

Estate recovery. Medicaid rules allow elderly citizens to transfer their assets to family members, and then qualify for Medicaid payments for nursing home care after 36 months. Spousal impoverishment provisions allow spouses to keep certain assets while the patients still qualify for Medicaid. Federal law prescribes how states may recover certain assets from the estates of program beneficiaries and provides states with optional mechanisms for recovering such costs. These laws help states recover additional assets from the estates of deceased beneficiaries. However, relaxation of spousal impoverishment rules could impoverish spouses and require them to seek other governmental income support payments. Also, state efforts to improve asset recovery are labor-intensive and may not yield financial benefits to Medicaid program budgets.

Community and managed care for elderly and disabled beneficiaries. States may seek home- and community-based waivers to provide community services to elderly and disabled beneficiaries who otherwise would be served in more costly institutions. Also, states may seek waivers to enroll the elderly and disabled in managed care plans.

Increase federal reimbursements by using provider taxes. Over the last eight years, many states have expanded their Medicaid programs by using taxes on health care providers—doctors, nursing homes, hospitals, institutions that care for the disabled and other providers. These funds are used to draw additional federal reimbursements of between 50 percent and 80 percent of state expenditures. In some instances, providers are willing to pay these additional taxes (or pass them on to customers with private insurance) because additional federal funds mean higher Medicaid reimbursements and less charity (uncompensated) care. Federal restrictions placed upon provider taxes in 1991 prevented states from guaranteeing that providers will get more back in reimbursements than they paid in taxes and required that taxes be imposed uniformly across all providers in a given class. These changes made provider taxes less attractive politically because taxpayers with private insurance could no longer be exempted from paying these taxes.

Provider taxes, however, may still be an attractive option for nursing homes and facilities for caring for the disabled because of the high proportion of Medicaid beneficiaries who use these facilities. Provider taxes have been criticized for explicitly increasing the costs borne by patients with private health insurance. Furthermore, they increase the cost of nursing home care to the minority of residents who use long-term care insurance or savings to fund their care. For this reason they may serve as a disincentive to plan for retirement.

Higher Education

When states have encountered fiscal problems, they have often reduced state appropriations for higher education. Over the last five years, higher education budgets have been cut, experienced little or no growth or have grown at less than the rate of inflation. As a result, higher education funding has shrunk as a share of state general fund spending. Although higher education funding rebounded somewhat in FY 1996, it represented only 13 percent of general fund spending, below the 15.4 percent it represented in FY 1988.[4]

Typically, the budget for state higher education is set by maintaining a base amount and adding allowances for enrollment and salary increases. In tough economic times, like during the national recession of the early 1990s, the base budgets for higher education and enhancements are subject to reductions. In most states, the base budget is not increased automatically to serve additional students. This places higher education at a disadvantage in the competition for state support and contributes to the lack of funding stability.

Officials at many higher education institutions have responded to budget cuts by raising tuition and fees, which often requires legislative approval. Since 1990, tuition and fees at public four-year institutions have increased nationally by 56 percent.[5] Tuition and fees often increase every year, but the rate of increase typically is faster when states are in the midst of budget problems. For example, tuition and fees at four-year public colleges increased an average of 7 percent annually in the 1989-90 and 1990-91 school years. But in the next two years, the rate of increase hit double digits, 12 percent and 10 percent, respectively. By the 1994-95 school year, the rate had dropped to 6 percent.[6] Other responses to reduced state support include very small or no increases in pay for faculty, capping enrollment growth, dropping academic programs and increasing class sizes. Some states, like Arizona, are making greater use of "distance learning" through the use of telecommunication networks, which has helped avoid capital outlay costs.[7]

The effects of reduced state support for higher education have been similar in many states. For example, tuition and fees in Oregon have grown by 65 percent over the last five years. and enrollment dropped from 64,900 in 1989 to an estimated 60,000 in 1995.[8] Officials report that the drop in enrollment is tied to increases in tuition and fees. At the same time enrollment has declined, Oregon has seen students shift to community colleges where tuition and fees have not risen as much as at the four-year institutions. Arizona actually is doing more to promote "2 + 2" learning—where students spend their first two years at a less expensive community college and the second two years at a joint facility operated by both a community college and a university.

In California, state financial support for the four-year college system dropped 6.6 percent between 1990 and 1995. This decrease contributed to tuition and fee increases of 130 percent since 1990, sharply driving up the costs of public higher education and contributing to an enrollment decline of 7 percent—more than 30,000 students in the last five years.[9] This drop in student enrollment marked the first time in California's history that there was not an increase in college enrollment during an economic recession. Other causes of the drop in enrollment were fewer course sections available and fewer outreach and recruit-

ment programs. Higher education officials deliberately cut enrollment in the early 1990s as they pursued a policy of accepting only as many students as the state budget funded. But even with a new policy of recruiting students aggressively and a one-year moratorium on tuition and fee increases imposed in the FY 1996 budget, campuses have failed to attract enough students to meet the legislature's target for the year.

In many cases, states only now are evaluating the effects that their recent budget decisions have had on higher education. The different funding environment that exists for higher education calls for some creative thinking and problem-solving if states are going to provide a quality education in an affordable manner.

Case Study: Higher Education Funding in Washington

Like most other states during the recession years of the early 1990s, Washington was faced with rapidly growing expenditures for health services, prisons and social programs for the elderly without corresponding growth in state revenues. Costs for these programs were increasing as a result of constitutional funding requirements, changing demographics, increasing caseloads, legislative policy decisions and medical inflation. These program expenses were instrumental in causing the legislature to decrease its support for higher education beginning in 1989.[10]

During the 1989-91 biennium, higher education accounted for 13.2 percent of Washington's budget. By the 1995-97 biennium, the share declined to 11 percent.[11] All other programs, with the exception of a minor drop in K-12 education, increased their share of state general fund support during the same period.

One result of the decreased state general fund support for higher education has been large increases in tuition and fees at public colleges since 1990. Between 1990 and 1996, tuition and fees increased by 65 percent, with the increases reaching double digits in 1993 (16 percent), 1994 (11 percent) and 1995 (15 percent). For 1996, the increase is 4 percent.[12]

There also have been other effects of the cuts in state general fund support for higher education. Plans were enacted to drop some academic programs at Washington State University. No payroll increases for faculty and staff were budgeted in the 1993-1995 biennium, and only a 4 percent increase for salary increases was included in the 1995-1997 biennium. Faculty and staff are looking at their first salary increase in five years as a result of the earlier cuts in the higher education budget.

Case Study: Higher Education Funding in Virginia

Like many other states, Virginia's general fund support for higher education has declined while tuition has increased. During the recession years of the early 1990s, general fund support for higher education was reduced by about 20 percent. In FY 1996, nongeneral fund support per full-time equivalent student exceeded general fund support for the first time. According to state officials, tuition increases are not a long-term option for additional revenues if higher education is to remain affordable: Between 1986 and 1994, tuition and fees increased 117 percent, while per capita income grew only 47 percent. Tuition increases were capped by the General Assembly at 3 percent for the FY 1996 budget year. In comparison, the average tuition increase in Virginia was 15.1 percent in FY 1993 and 10.4 percent in FY 1994.[13]

With the prospect of large enrollment growth, coupled with constraints on both general funds and tuition, Virginia's colleges and universities have started to address how to maintain quality yet ensure student access and affordability. The 1994 appropriation act set out the direction and criteria for higher education to develop a plan to effect long-term changes. The objective behind the restructuring is to educate more students at a lower average cost, while improving the quality of education. The proposals for restructuring fall into four broad areas:

Moving students through the system more quickly by managing enrollments. The principal strategy of managing enrollments includes reducing credit hours for most undergraduate degrees from 128 to 120. Also, full semesters would be offered during the summer session and tuition incentives would be provided to students to increase summer enrollments. "Credit for competency" would allow students to "test out" of courses or to otherwise earn academic credits outside the classroom. Plans also include developing articulation agreements with community colleges to allow students to take the first two years of a degree program at lower cost. Part of the strategy would include restructuring tuition to create disincentives for repeating courses or taking unnecessary electives.

Seeking greater productivity from current faculty and resources. This includes establishing minimum expectations for faculty and conducting post-tenure evaluations to ensure teaching effectiveness and appropriate workloads. This broad strategy also includes providing additional capacity through distance learning initiatives, new campuses and higher education centers. Other elements of the plan reallocate faculty resources from graduate to undergraduate programs and eliminate costly graduate programs or low-enrollment baccalaureate programs. Other plans include collaboration among institutions to offer courses that may not have sufficient enrollment on one campus, which allows for team teaching and sharing faculty across departments and curricula.

Changing the definition of how and when learning occurs and improving the quality of instruction. One plan being examined under this strategy is the development of courses that use computer-based discussion and materials rather than the standard lecture format. Faculty would be trained to create course materials for both traditional classes and self-directed courses using computer-assisted instruction and other technologies.

Implementing administrative changes to reduce overhead, generate additional revenues and improve service to the instructional program. This strategy would implement more out-sourcing and privatization of operations to cut costs or generate revenues. Other plans include improving space utilization, sharing space at colleges, streamlining operations and delegating administrative responsibility to academic departments. Another possibility is centralizing functions such as human resources, accounting and procurement.

The broad guidance on restructuring higher education in Virginia provided by the legislature and its subsequent hands-off approach to its implementation is being viewed as a successful approach. The results thus far seem to indicate that colleges and universities can reduce their costs at a time of rising enrollments and tight state budgets.

Corrections

Corrections expenditures represent a rapidly growing area of state budgets and show no sign of slowing. In 1986, state corrections spending for adult prisoners (excluding capital costs) was about $7 billion. By 1996, corrections spending increased to $20 billion and now accounts for almost 6 percent of state general fund expenditures.[14]

Growth in corrections spending is being driven by several factors:

- The number of state prisoners has increased substantially, growing from 428,000 in 1984 to more than 1 million by mid-1995.[15] This has caused states to build more prisons, which has led to increases in both capital and operating costs.
- States are lengthening prison stays. Many states have increased minimum sentences for violent and nonviolent (mostly drug) offenders and have imposed "truth in sentencing" provisions that require convicts to serve a set percentage (say, 85 percent) of their sentence before being released. In recent years, many states also have imposed "three strikes and you're out" laws, which generally mandate life imprisonment for individuals with a third felony conviction.
- Longer prison stays mean older prisoners. Health care costs for elderly prisoners are higher than costs for younger prisoners.
- Court decisions in some states have required prison improvements or additional prison beds.

This section explores several policy options designed to reduce state corrections costs. It discusses privatization, community corrections and mechanisms to control the size of inmate populations.

Privatization. The number of privately operated state correctional facilities in the United States has increased from zero in 1983 to more than 80 in 1995, although they remain a small portion of the total facilities in the United States.[16] Contracting for the construction and operation of private facilities allows states to avoid up-front capital construction costs and may provide operational savings as well. Proponents also cite the benefits of competition in keeping state facility costs down and the financial benefit for state and local governments of having taxable instead of tax-exempt facilities. Privatization in the correctional system can range from small operations such as food service and health care to the entire operation of a prison.

Opponents of prison privatization cite lower wages and benefits that could reduce living standards for correctional employees, the concern that lack of competition will eventually allow private companies to enjoy monopoly pricing power and the compromising of food service and medical care in order to control costs. There is also the concern that even under a private contract, the state remains responsible for any problems that may occur.

Although half the states allow private management of correctional facilities, few have conducted comprehensive evaluations of private facilities versus public facilities. In the states where evaluations have been conducted, the results are somewhat mixed, as the examples from Tennessee and Texas demonstrate.

Case Study: Privatization in Tennessee and Texas

In 1991, Tennessee enacted legislation allowing for the private operation of one of the state's medium security prisons. One objective of the legislation was to generate data that could be used to compare public and private operations of similar kinds of

facilities. Renewal of the private contract could occur only if the contractor provided the same quality of services as the state at a lower cost or if the contractor provided services superior to those provided by the state at essentially the same cost. The law also required that an evaluation be conducted to assess the operations.

The evaluation, conducted by the Fiscal Review Committee, was released in 1995 and compared the cost and quality in similar correctional institutions (two run publicly and one run privately). The evaluation found that quality measures on key factors like health care, prisoner treatment and security were slightly higher in the privately run facility. However, the average daily operating costs in the private facility also were slightly higher—$33.78 per inmate per day in private facilities versus $33.18 per inmate per day in public facilities. This translated to an average annual cost of $12,330 per inmate in the private facility versus $12,111 in the public facilities, a difference of approximately 1.02 percent. Based on the evaluation, the state extended the contract for the private facility until February 1997. At that time, the state will consider issuing a new contract.

Because of the rapid growth in its prison population and the rising costs of incarceration, in 1987 Texas authorized the Texas Department of Corrections (now the Department of Criminal Justice) to contract with private vendors to finance, construct, operate, maintain or manage correctional facilities. Privatization was seen as a potential means of increasing the capacity to house prisoners at a level of quality equal to that provided by the state but at a lower cost.

The legislation authorizing private prisons contained several guidelines including limiting the number of prisoners in the facilities, restricting the contracts to minimum or medium security facilities and retaining accreditation from the American Correctional Association. To ensure that the state would save money on the private contracts, the law also required that private vendors provide their service at a cost savings of at least 10 percent under the state's cost. The Legislative Budget Board was directed to determine the cost figures to be used by the four prisons that were authorized to operate under private management.

The law also required that the Texas Sunset Advisory Commission analyze the cost and quality of private prison services compared with the cost and quality of any similar state service. This proved to be a difficult task because the Department of Criminal Justice did not (and still does not) operate correctional facilities comparable to those being operated privately. Nevertheless, the Sunset Advisory Commission released its analysis in March 1991 and found:

- Through the end of FY 1990, the cost of operating the private prisons was more than 10 percent less than the cost if the state were to operate similar facilities;
- The four private prisons contributed to state and local economies by each paying an estimated $400,000 in state and local sales taxes, franchise taxes and payments in lieu of property taxes;
- The private facilities were in general compliance in many categories of operation but had problems in education and training programs; and
- All four facilities received accreditation from the American Correctional Association.

Because of the overall successful experience of the first four privately run correctional facilities, Texas has increased its number of privately operated correctional facilities.

Community corrections. Community corrections is the term given to those sanctions that punish an offender within his or her own community, typically falling between traditional probation and a prison sentence. The most commonly used community corrections programs are intensive supervised probation, day reporting centers, house arrest and electronic monitoring, restitution, community service and fines. According to several studies, community corrections programs can be four to five times less expensive than incarceration. For example, a 1987 study by the Rand Corporation found that the annual cost for intensive probation ranged from $1,500 to $7,000 while annual costs to be housed in a state prison ranged from $9,000 to $20,000. Annual costs for other community corrections programs fell between these amounts.[17]

Community corrections have the potential to reduce state correctional system costs if convicted offenders are sentenced to intermediate punishments instead of prison. When integrated into the menu of sentencing options available to judges, community corrections programs can help states avoid the need for new prison beds. However, if community corrections sanctions supplement prison sentences instead of supplanting them, these programs can actually increase system costs in both the short term and the long term. Further, if the courts are not selective in choosing candidates for community corrections, offenders in community corrections programs may commit new crimes and end up in prison, increasing overall system costs.

Community corrections programs, used properly, can alleviate prison overcrowding and help ensure that the most violent offenders serve a longer portion of their sentences because prison space is available to house them. In some states, these programs have reduced recidivism rates for defendants awaiting trial. The downside to community corrections programs is that public confidence can be eroded by highly publicized failures that are inevitable in all sentencing alternatives.

Community corrections programs cannot provide overnight savings. It takes states several years to create a community corrections infrastructure, educate court officers about the system and allow judges time to develop confidence in the system. States have found that diverting a portion of the correctional system's operating budget into community corrections—rather than providing new, additional funding for the program—can help ensure that community corrections supplant prison sentences instead of supplementing them.

Case Study: Community Corrections in Connecticut

In the late 1980s, the Connecticut General Assembly created the Alternative Incarceration Program (AIP). The program was implemented to address two main needs: to alleviate jail and prison overcrowding and to provide judges with a larger menu of sentencing options. Administered by the courts, the program identifies and diverts prison-bound criminals into community-based programs that include intensive supervision, drug and alcohol testing and counseling, education, anger management and family counseling. Approximately 4,200 offenders are supervised daily by private organizations that have contracted with the courts. During FY 1993-94, administrative costs for the program accounted for 2.6 percent of the program's $25 million budget.

Preliminary results from the first two years of a five-year study of the AIP program have been favorable:

- The average annual cost for a slot in the AIP Program is $5,000 (compared with Connecticut's annual cost of $25,000 for housing an inmate in prison). This produces an annual cost savings to the state of approximately $84 million. The

program also eliminates the possible need for $600 million in capital costs for new prisons.

- Defendants in the AIP program pending trial had much lower re-arrest rates than non-AIP counterparts (10 percent versus 26 percent) and were four times less likely to be sentenced to prison upon conviction.
- Recidivism rates among AIP participants were lower than those offenders who were sentenced to prison (24 percent versus 30 percent).
- Other identified benefits of the AIP Program have included more jail and prison space being made available for more violent offenders, an increase in the length of sentences served because jail and prison space is available and, through the various AIP sentencing options, judges have been able to make the punishment better fit the crime.[18]

Controlling the size of the inmate population. As previously noted, the burgeoning prison population is an important factor in explaining the growth of state corrections budgets. More inmates mean more prisons. Although building new prisons requires sizable up-front expenditures, many states issue bonds to cover the expense. More problematic for state budgets are the ongoing costs to operate prisons: Two-thirds of corrections budgets are used to operate, maintain and staff prisons.[19]

In addition to housing more prisoners, states also are faced with growing incarceration costs. For example, the Bureau of Justice Statistics reported that the average per-inmate cost in 1984 was $11,302. But by 1990, the latest year for which comprehensive data are available, the average cost had grown to $15,513.[20]

Recognizing that managing the number of inmates is key to managing corrections costs, some states have taken steps to control the size of the inmate population. Sentencing reform in the states often has included mandatory minimum and other sentence enhancements that increase prison populations. Sentencing guidelines, or "structured sentencing," have sought to create a more manageable system that balances sentencing policy with available resources. Sentencing guidelines generally have been developed by a commission created and overseen by the legislature. The commission has the ongoing responsibility for monitoring and measuring changes in sentencing policy and the effect on correctional resource needs.

Structured sentencing typically uses a matrix or grid format that plots the severity of the crime with prior criminal history to determine the sentence to be imposed. Guidelines systems can, in a uniform and predictable manner, build in shorter and alternative prison sentences for less serious crimes and offenders and reserve finite prison space and resources for the most habitual and dangerous offenders. By 1995 legislatures in 16 states had approved and implemented some form of sentencing guidelines. (For more information see, Hunzeker, "State Sentencing Systems and 'Truth in Sentencing.'")

Case Study: Structured Sentencing in North Carolina

In 1993, North Carolina enacted the Structured Sentencing Act, a new sentencing law that, among other things, abolished parole and required all offenders to serve their entire sentence. Although these kinds of provisions lengthen prison stays and require additional funding, the new law also created a system that balances sentencing policies with correctional resources.

The 1993 law, which became effective on Nov. 1, 1994, created a felony punishment chart or sentencing grid that balances the number of offenders sentenced to prison with

the number of available prison beds. Under this program, judges determine the seriousness of an offender's crime, the offender's past criminal record and how much prison space is available. The grid then identifies the level of punishment, ranging from an alternative sentence to a prison sentence. In some instances, the judge has discretion to choose either. If the punishment is incarceration, the grid provides a range of minimum and maximum sentences. First and second offenders who commit certain nonviolent crimes may be given suspended sentences if they successfully complete alternative punishments such as intensive probation, house arrest or boot camp. Unlike some other states' structured sentencing, North Carolina's law does not provide guidelines but instead provides edicts that must be followed.

At the time the grid originally was developed, all sentences were designed to match the expected prison capacity for five years. Since that time, the grid has been adjusted to reflect increased penalties for selected low-level crimes (such as misdemeanor assaults) and to accommodate changes to parole provisions that were in place prior to the 1993 law. Overall, the state is close to its original inmate projections.

Evaluations to date indicate that the Structured Sentencing Act is accomplishing its goals, including the establishment of truth-in-sentencing, expanded use of less expensive sanctions, more prison space being reserved for more violent offenders and better overall use of the state's correctional resources. Although the state's new approach to corrections and sentencing policy has required significant up-front costs (largely to fund prison construction that will be completed in late 1997), the result is that North Carolina's prison capacity is expected to meet or exceed the state's prison population until about 2004.[21]

TANF/Welfare

State expenditures for family assistance—formerly the Aid to Families with Dependent Children (AFDC) program and now the Temporary Assistance to Needy Families (TANF) program—and other welfare programs (primarily SSI supplements and general assistance) are about 4.6 percent of the general fund budget. Therefore, welfare spending reductions will not significantly affect state budgets.

The primary state welfare program is the state-federal TANF program. (States must transfer from AFDC to TANF by July 1, 1997, which most states already have done.) TANF restructures federal financing for family assistance. Rather than the federal government matching state welfare spending as they did in AFDC, states receive a set amount of funding—the block grant. The block grant does not change automatically when a state's assistance spending increases or decreases. States also have considerable new flexibility to revise their welfare programs to reduce spending, including changing benefit levels and eligibility requirements.

The TANF program limits states' financial flexibility in three important ways. First, federal legislation requires that states achieve work participation requirements that increase over time. Minimum participation starts at 25 percent of all adults working at least 20 hours a week in FY 1997. It increases gradually to 50 percent of all adults working 30 hours a week by FY 2002. Failure to meet these requirements will result in a penalty of 5 percent of the state's block grant. The penalty increases by 2 percent each year the state continues to fail to meet the participation requirements, up to a maximum of 21 percent. Second, the maintenance of effort requirement limits how far states can reduce their own spending without losing federal funds—80 percent of their FY 1994 spending levels initially and 75 percent of those levels for those states that meet the work participation rate requirements.

Reductions below these levels would result in a dollar-for-dollar reduction in the federal block grant. Third, the legislation establishes a contingency fund that provides additional federal funding for states during serious economic downturns. Access to this fund is triggered by increases in the state's unemployment rate or food stamp enrollment. This fund provides states with some protection against a recession, but restricts how states can reduce their own spending. To get money from the contingency fund requires a state to spend at the 100 percent maintenance of effort level. Any additional state spending would be matched at the Medicaid rate.

The block grant system shifts the financial risk of welfare programs to the states. Reductions in family assistance spending will go back completely to the state. At the same time, increases in spending will come out of state funds. And states must be concerned with meeting their work participation rates and getting families into work so that they can support themselves. This increases the stakes of states' efforts to reduce welfare spending as well as the importance of their decisions about investing funds in welfare-to-work programs.

Reduce or eliminate non-AFDC welfare programs. In 1995, 42 states had some type of general assistance program that provides nonfederal cash assistance for persons not eligible for AFDC or SSI. Typically, cash assistance is provided to single adult males who do not work or have exhausted unemployment benefits. General assistance is usually the last safety net program available to this segment of the poor population. (Disabled citizens who are unable to work typically qualify for Social Security or SSI.) Unlike the AFDC program, general assistance programs do not receive matching federal dollars. Therefore, eliminating or reducing general assistance does not trigger federal penalties or a loss of federal matching money.

Case Study: Welfare Reform in Michigan in 1991-92

Michigan made substantial revisions to its welfare programs in 1991 and 1992. The state's experience with reforms to general assistance and AFDC suggests that reforms can have positive effects on state budgets and recipients' behavior but that the effects develop slowly. The experience also suggests that policymakers have to be wary about displacement effects—that people removed from one program may overload another one.

General assistance. On Oct. 1, 1991, Michigan terminated its general assistance program, which was a cash assistance program that provided aid to adults without dependent children who were not eligible for any other form of state or federal public assistance. In March 1991, Michigan's general assistance population was 106,000, and in the last full year the program was in effect (FY 1990), Michigan budgeted $235 million for it. The program provided beneficiaries with $160 per month. Goals of the termination were to reduce public spending, increase employment levels and make a dependent population self-sufficient.

According to the Senate Fiscal Agency, termination of general assistance reduced state expenditures by the amount of direct costs for the program—$235 million in FY 1990, the last full year of operation. An evaluation by the University of Michigan School of Social Work found the following:

- Thirty-eight percent of former beneficiaries found at least part-time work in the two years after the program ended, usually in jobs that paid about $5.50 per hour.[22]
- Twenty-six percent of former beneficiaries were enrolled in either federal or state disability benefit programs by the summer of 1993, as opposed to 2 percent before general assistance was terminated.

- Twenty percent moved into AFDC (a program for parents of minor children).
- Sixteen percent depended upon a spouse's benefits from AFDC, a disability program or other public assistance.
- Demand for space in homeless shelters in Detroit more than doubled after general assistance was terminated.

The evaluation results also suggested that the fairly impressive level of employment reported by former beneficiaries could be misleading. Poor health and a lack of skills tended to make beneficiaries take jobs like baby-sitting, running errands and raking leaves. Poor health and lack of productive personal contacts, the report suggests, will mean that former beneficiaries will have difficulty keeping jobs.

The findings by the University of Michigan School of Social Work, although they have not been subjected to critical evaluation by advocates of repeal of the general assistance program in Michigan, suggest that much of the public expenditure the program represented has been diverted to other forms of public assistance. The Michigan Senate Fiscal Agency, after analyzing a variety of public assistance caseload data, could not find definitive empirical support for the University of Michigan survey findings.[23]

Family Assistance. On Oct. 1, 1992, the state put into effect a program called "To Strengthen Michigan Families (TSMF)." This program contained 21 welfare reform policies, many of which revised traditional provisions of AFDC. Revisions included:

- A requirement that all adult welfare recipients must enter a "social contract," that is, must engage in employment, education, training, self-improvement activities or community service for at least 20 hours a week;
- A provision allowing welfare recipients to keep a larger proportion of earnings while on welfare;
- Fewer restrictions on the eligibility of two-parent families to receive welfare; and
- A provision allowing children to earn and save without affecting welfare benefits.

These revisions were central to the program's goals of stabilizing family structures, encouraging the habit of gainful employment, creating greater self-reliance and, through those means, reducing welfare dependency.

TSMF focused on program revisions rather than cost savings; and it is a long-term program. An evaluation of the first year of the program yields encouraging findings even in the short term, nearly all of them, according to the Michigan Department of Social Services, "in directions positive for both clients and taxpayers."[24]

The changes are marginal, as might be expected in a program intended to alter behavioral patterns. Not all the intended changes in client behavior showed up in the first year of the program, nor were the findings all consistent with each other. These were the major findings of the evaluation:

- TSMF had no significant impact on the level of employment or earnings among welfare recipients in its first year, either for adults or for children.
- Participation declined. Under TSMF, people who entered a welfare program—AFDC, State Family Assistance (a state-funded program for families not eligible for AFDC), food stamps or Medicaid—were one percentage point less likely to continue for 12 months than people in the traditional program. (Because measurement was simultaneous in control groups, it is thought that changing economic conditions did not affect this finding.)

- People entering the new program were 1.5 percent more likely to combine work and welfare than beneficiaries in the previous program.
- Medicaid participation increased for adults but fell for children. This occurred because TSMF allowed two-parent families to transfer from State Family Assistance, where they were not Medicaid-eligible, to AFDC, which confers Medicaid eligibility. But children's participation in Medicaid fell because overall AFDC eligibility declined.
- By the end of the evaluation period, welfare payments were beginning to fall. The amount is statistically insignificant but is consistent with the expectation that as work participation increases, payments should fall.

The findings by the Michigan Department of Social Services suggest that changing the conditions of welfare grants and providing financial incentives can alter the behavior of welfare beneficiaries in the direction of greater self-reliance. But they also suggest that changes in income-support programs can have adverse effects on other programs because of beneficiaries' movement from one program to another. The Michigan Senate Fiscal Agency has been unable to substantiate the findings.[25]

Reduce TANF benefit levels. Under TANF, states are no longer restricted in how much they can reduce benefit levels. Cash benefit levels for poor families have not kept pace with inflation during the last decade. Although some of this loss in purchasing power has been offset by increases in federal food stamp benefits, poor families have already experienced a decline in benefits when adjusted for inflation. Cuts will impose further hardships on poor TANF recipients for limited budget savings.

Change eligibility levels. States have discretion to change eligibility levels for TANF. These are the income, asset, poverty and household size factors that states use to determine eligibility for benefits. In recent years, states have tried to reduce costs by imposing a family cap that denies additional benefits for additional children, requiring teen parents to live with their families, changing the definition of poverty or imposing work or training requirements on beneficiaries. Most of these changes have occurred in the mid-1990s so there are few data on whether they have reduced state expenditures. However, most experts do not expect significant savings from these eligibility changes, particularly savings large enough to offset the increased administrative costs of imposing the new requirements.

Reduce administrative costs. A sizable share of the cost of welfare programs is administration. Administrative costs come out of the TANF block grant so reducing these costs saves state money. Alternatives for reducing administrative costs include improving computer systems, reducing complex eligibility requirements, using electronic funds transfer (EFT), increasing per worker caseloads and developing one-stop shopping centers that would combine other state and federal benefit program administration in one location. Some of these strategies—such as improved computerization and EFT—may require an up-front investment to achieve productivity savings. Others, such as increasing caseloads per worker, run counter to recent welfare reform efforts that seek to impose work activity requirements on recipients. For these reasons, administrative cost reduction holds limited promise for reducing program expenditures.

Notes:

1. For more information, see Steven D. Gold, et al, "Public School Finance Programs in the U.S. and Canada, 1993-94" (Albany, N.Y.: Center for the Study of the States, 1995).
2. National Association of State Budget Officers, *1995 State Expenditure Report*, p. 93.
3. Martha King and Steve Christian, *Medicaid Survival Kit* (Denver: NCSL, 1996).

4. National Association of State Budget Officers, *1995 Expenditure Report* (1996) and *1988 State Expenditure Report* (1988): various pages.

5. The College Board, "Average Annual Increase in Tuition and Fees at Colleges, 1987-88 to 1995-96" (New York, November 1995, photocopied table).

6. Ibid.

7. National Association of State Budget Officers, "State Innovations in Higher Education Finance and Governance" NASBO Information Brief 4, no. 1 (April 25, 1996).

8. Oregon State System of Higher Education Institutional Research Services, "Base Enrollment, Fall 1965-66 through 1994-95 Headcount" (Salem, November 1995, photocopied table).

9. California Legislative Analyst's Office, "Higher Education State Funding 1990-91 through 1995-96" (Sacramento, November 1995, photocopied spreadsheet).

10. Washington Office of Financial Management, *State Support for Higher Education: What Is It? What Should It Be?* a briefing paper prepared for the Governor's Higher Education Task Force (Olympia, November 6, 1995): 3.

11. Ibid., 4.

12. Washington State Senate, Senate Ways and Means Committee, "Washington State 1995-97 Operating Budget" (Olympia, November 1995, photocopied table).

13. Virginia Senate, Senate Finance Committee, *Higher Education* (Richmond, 1994): 7.

14. National Conference of State Legislatures, *State Budget Actions* (Denver: NCSL, various years).

15. U.S. Department of Justice, Bureau of Justice Statistics (Dec. 3, 1995, press release).

16. Elizabeth Pearson and Donna Lyons, "Privatization of State Corrections Management," *NCSL LegisBrief*, 4, no. 6, Jan. 1996.

17. Joan Petersilia, *Expanding Options for Criminal Sentencing*, (The Rand Corporation, 1987): 83.

18. For more information on this program see *Longitudinal Study: Alternatives to Incarceration Sentencing Evaluation, Year 2*, State of Connecticut, Judicial Branch, April 1996.

19. Jill Ross Schmelz, "Analyzing the Growth of State-Local Corrections Spending" (Albany, N.Y.: The Nelson A. Rockefeller Institute of Government, July 1995): 7.

20. Discussion with staff at the Bureau of Justice Statistics Clearinghouse, July 10, 1996.

21. For more information on this program, see North Carolina Sentencing and Policy Advisory Commission, *1995 Progress Report on Structured Sentencing*, July 1, 1996.

22. Percentage and other figures are based on a survey population. See Sandra K. Danzier and Sherrie A. Kossoudji, "When Welfare Ends; Subsistence Strategies of Former General Assistance Recipients," *Final Report of the General Assistance Project* (Ann Arbor: University of Michigan School of Social Work, February 1995).

23. The Michigan Senate Fiscal Agency, after analyzing a variety of public assistance caseload data, could not find definitive empirical support for the University of Michigan survey findings.

24. Alan Werner and Robert Kornfeld, *The Evaluation of To Strengthen Michigan Families: Second Annual Report—First-Year Impacts* (Ann Arbor, Mich.: State of Michigan, Department of Social Services, December 1994).

25. The Michigan Senate Fiscal Agency notes that "early evaluations did appear somewhat ambiguous. However, using a longer time reference indicates that TSMF has had a significant impact on the AFDC program. In addition, the Senate Fiscal Agency also found no empirical data that would lend credence to the hypothesis that these changes have resulted in the 'movement from one program to another' of these recipients.

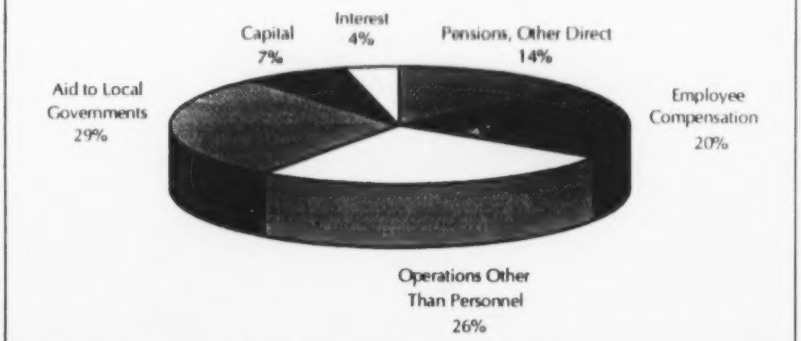
5. State Expenditures That Cut Across Programs

Chapter 4 examined possible savings in large state programs like education and health care. This chapter takes a cross-sectional approach to potential state cost reductions by looking at expenditures that are not tied to a particular state program but instead cut across program lines—government employment and aid to local governments.

Government Employment

Government is a labor-intensive activity. In 1992, state governments employed 4.6 million people. More than 25 percent of them were part-time employees, but the full-time-equivalent (FTE) number was 3.8 million employees. These employees were paid more than $140 billion in salaries, wages and fringe benefits, representing 20 percent of all state spending and 43 percent of state spending on current operations (see figure 3).[1] (Current operations are recurring expenditures except for intergovernmental payments and interest on debt.) The resources devoted to state employment, as well as its size, visibility and growth, make it a source of savings whenever reductions in state government are sought.

Figure 3. Components of Total State Spending, FY 1992



Source: NCSL compilation based on Bureau of the Census reports

Although short-term reductions in state employment are not uncommon, the number of public employees tends to grow at a fairly steady rate. From December 1994 to December 1995, public employment fell in 20 of 48 reporting states, but such reductions are often temporary: From 1990 through 1995, net employment fell in only seven states.[2] Public sector employment is less sensitive to cyclical changes in the economy than private sector employment. Private sector employment is highly responsive to recessions and recoveries: Employment can fall in absolute numbers during a recession, and unemployment rates shrink when recoveries create new jobs. The public sector is not impervious to cyclical change, but its fluctuations are moderate compared with those of private sector employment in part because demand for government services grows when the economy is weak.

Public employment tends to grow steadily because almost 50 percent of public employees (49.7 percent of state and local FTE employees in 1992) work in education. Education employment tends to be driven by demographics. The effect of population-driven growth in education is to smooth out other fluctuations in state and local employment growth.

Public employment growth rates tend, over time, to be close to state population growth. From 1990 to 1995, state and local employment growth in 34 states was within one percentage point of population growth. The states in which public employment fell in that period (California, Maine, Maryland, Massachusetts, Michigan, New York, New Jersey and Vermont) tended to be states whose economic and demographic growth was far below the average for the 50 states.[3]

Obstacles to Reducing Government Employment

Hiring freezes and calls for employee reductions are ineffective for several reasons.

- Layoffs are more difficult for state governments than for the private sector for technical reasons. Even without regard to labor agreements where unions exist, state personnel rules were designed by an earlier generation to make it difficult for elected officials to use jobs for patronage. Those rules make it hard to fire people without abolishing jobs.
- Even when jobs are abolished, it may be hard to reduce employee numbers. Civil service rules often provide "bumping rights" for people who do lose jobs, which means that they can replace other people in a civil service system. Someone eventually is out of work, but the process can take months or years as the result of a single employee's displacement.
- Hiring freezes can, in theory, reduce employee numbers by natural attrition, but they usually make exceptions for emergencies. The officials who decide what openings merit emergency filling may be more sympathetic to agency needs than to elected officials' call for fewer employees. It can be difficult to provide the necessary administrative oversight to make a freeze effective.
- According to some analysts, bureaucratic values are so focused on growth that officials are highly resistant to reductions in force, so they create procedural obstacles, or at least do nothing to facilitate calls for workforce reductions.
- Growth in an occupation that is widely deemed essential (prison guards) can overwhelm reductions in occupations that are being phased out (ward attendants in state mental hospitals).
- Demand for some state services increases during recessions when calls for restrained state employment are most frequent. Health, welfare, Medicaid, children's services, and social service workloads increase during recessions, and law enforcement and public education workloads may, too.

Techniques for Reducing Government Employment

Three ways that state governments have reduced public employment and compensation are:

- Use of a special commission to recommend efficiencies that lead to reduced employment;
- Early retirement incentives; and
- Privatization of governmental functions

These techniques address some of the obstacles listed above. In various ways they circumvent or effectively resolve bureaucratic inertia, employee resistance and economic and legal obligations to existing employees. None of them can live up to the greatest claims of their advocates, and each of them can lead to new problems while attempting to solve old ones.

A fourth method is the severance program the governor of Rhode Island proposed in his budget for FY 1997. State employees who agreed to leave state service voluntarily on or before July 1, 1996, and agreed not to accept employment from any state agency for five years would receive a severance benefit equal to two weeks' pay for each year of actual state employment plus six months' state health insurance coverage.

Case Study: The Maine Productivity Realization Task Force

Maine Governor Angus S. King Jr. appointed the Productivity Realization Task Force in February 1995 to recommend ways to save money through enhancing productivity and reducing the number of state employees. The 13-member task force included legislators, state administrators and business people from the state. The recommendations it developed over a period of 10 months should produce $45 million in net general fund savings in the 1996-97 biennium. Another $14.4 million in biennial savings will be reinvested in technology and program improvements. Savings for the single fiscal year 1997 will amount to about 1.6 percent of the general fund budget.

Savings will result from the elimination of 1,352 state positions (more than 10 percent of the total state workforce of 13,205). Two-thirds of the positions became vacant as the result of a hiring freeze and 476 people were laid off. Agency reorganization and internal agency consolidation allowed for elimination of 14 percent of the managerial and supervisory positions in state government and accounted for 20 percent of all positions eliminated. This was made possible by encouraging agencies to shift from a rigid program structure to functional groupings that encourage team activities, through upgraded technology and through new approaches to administration and management.

In keeping with a new focus on function rather than program, the department of Conservation merged its Bureau of Parks and its Bureau of Public Lands into a Bureau of Parks and Land. The State Planning Office abandoned a vertical agency organization in favor of cross-functional teams focused on functions mandated in law. The departments of Human Services and Transportation consolidated and centralized offices and activities.

The focus on technology gave agencies resources to modernize computer systems, management information systems and telephone systems to reduce the need for personnel and increase service capacity, for example, with voice mail. Toll-free lines and voice-response systems can provide responses to routine questions from Human Services clients. Document imaging will replace typing documents into computer files. Various law enforcement agencies have automated and coordinated their licensing and inspection functions.

A further innovation is grouping state agencies with shared personnel, financial and other administrative services to replace agency-by-agency duplication. Groupings are on functional bases. For example, the departments of Agriculture, Conservation and Environmental Protection have been grouped as one "cluster" to share administrative

services. Another cluster will be the departments of Defense & Veterans' Affairs and Public Safety. Social services agencies make up another cluster.

Finally, agencies consolidated or combined internal activities to do away with separate administrative structures.

The state created a special Support and Outplacement Services Team to assist people who lost their jobs and to coordinate services for them from their own and other state agencies. The governor (with whom the legislature worked closely throughout the process) summarizes the result as "a government that is optimally productive, effective, accountable, affordable and responsive."[4]

Early Retirement Incentive Programs

Many state governments—as many as one-third in the period from 1990 through 1995—have created early retirement incentive programs designed to reduce the ranks of employees without layoffs, cut personnel costs enough to cover the increased pension obligations and cut spending overall. To encourage voluntary early retirement, such programs offer some category of employees various incentives that are not ordinarily available. Usually the incentive is available for a short time—approximately three months—with enough advance notice that employees can consider their options. Incentives vary and may include provisions to allow retirement with a normal pension at an earlier age than usual, a pension benefit increment, increased health insurance benefits or a combination of these.

These programs have a number of fiscal and management advantages:

- They have the potential to reduce the number of employees and save salary costs.
- Savings can be significant since such programs are usually aimed at long-term employees, who tend to have higher salaries.
- Programs can improve efficiency if they eliminate less-efficient employees. A covert but never officially stated purpose of such incentive programs can be to encourage "deadwood" to retire.
- They avoid the damage to morale done by involuntary layoffs and can enhance morale by giving the employees who remain opportunities for promotion.
- Employees welcome such opportunities; they generally consider they have nothing to lose. Employers generally welcome them as well.

The advantages of early retirement incentive programs can be lost if a program is not carefully designed. Policymakers have to be careful not to swap short-term savings in salary and benefits for greater long-term liabilities to the pension system. Many studies contend that the real potential for savings from early retirement incentives lies in reduction in the number of employees—not in the replacement of senior employees with juniors.

If so, an early retirement program is most effective as a cost-saving device only when linked to a commitment to reduce public employee payrolls and keep them reduced. Thus, an early retirement incentive program is a cost-saving device only when it is combined with a broader program of reducing the size and activities of government.

Those are not the only potential pitfalls. Without very careful design, an incentive program may merely accelerate retirement decisions by a few months at substantial cost to the state. An early retirement incentive program that rewards people for retiring six or nine months

earlier than they would have anyway is likely to be a waste of resources. An incentive program that merely shifts costs from current salary and benefit lines to the pension system is badly conceived as well, since it is usually considered poor policy to shift current expenditures from current taxpayers to future taxpayers. Almost unavoidably, retirees will include experienced employees whom agencies might benefit from keeping.

Cost-shifting is especially a danger when state provisions allow the local government participants in a statewide pension plan to retire at no additional cost to the local government, with the pensions costs absorbed by state government. This provides a state subsidy to local governments on an erratic and unplanned basis.

Case Study: Early Retirement Programs in Minnesota and Virginia

The following discussion of things to look out for in the design of early retirement incentives is based on thorough evaluations of programs in two states, Minnesota and Virginia. The Minnesota program was offered to city, county, school district, university and state employees in 1993. The Virginia program was available to a similar range of state and local employees in 1991. Both evaluations offer pointers for the future, as well as explanations of some unexpected problems that emerged as programs were administered.

In both Minnesota and Virginia, auditors found that the early retirement programs brought a net fiscal loss to state government.

- In Minnesota, the increase in pension and insurance costs was about $100 million on a present-value basis for about 3,300 early retirements. This seemed particularly expensive since it appeared to the auditors that 50 percent of those who received augmented early retirement benefits would have retired in 1993 without the incentive (partly because the program included special incentives for employees over age 65 that attracted a very large proportion of such employees to retire).
- In Virginia, the increase in pension costs was about $238 million (present value) to cover the additional retirement benefits for the 3,535 state employees who took early retirement. The costs in Virginia were higher than in Minnesota. The Virginia program was available to younger employees than the Minnesota program, which means that on average benefits will be paid for more years. Unlike the Minnesota program, Virginia included no special incentives for employees over age 65 (whose life expectancy is shorter).

Auditors in both states recommend that early retirement incentives ought to be targeted to programs, departments or agencies that have an immediate need to downsize or reorganize and not made available across state government.

- The Minnesota finding is that downsizing is essential for savings from an early retirement incentive, and those savings are likely to result from budget decisions independent of an incentive program. Therefore, the primary benefit of a retirement incentive program is to ease the removal of employees who would have to be dismissed anyway.
- The Virginia recommendation is that early retirement incentives should be one tool among others available to programs that have to downsize or reduce spending, not a governmentwide policy for its own sake.

Because savings depend on reducing employment, vacancies need to be tracked and replacements controlled in a more sophisticated way than states ordinarily practice.

- In Virginia, the original goal was a net savings of $37.1 million for FY 1992's state budget (without taking any additional payments to the Virginia Retirement System into account). Saving $37.1 million required that no more than 50 percent of the retirees be replaced. However, replacements were not tracked, and no method existed for deciding how to weigh the costs of (1) using salary savings to fill vacant positions other than those created by the early retirement program and (2) re-employing retirees as contractual, part-time or temporary employees—a widespread practice. Although the goal of budgeting $37.1 million less was met, it appears that only part of the savings came from early retirements and that agencies used a variety of sources to live within their reduced budgets.
- In Minnesota, 61 percent of positions vacated remained empty for somewhat less than a year. This was a slightly higher proportion than was needed to cover program costs for state government. However, to cover costs, the positions would have to remain permanently unfilled, and within a year agencies planned to fill many vacancies. Moreover, no data existed on the salary savings that had been used to fill other, existing, vacant positions.

There are unforeseen costs, not all of them monetary.

- Compensation paid to temporary employees.
- Recruitment and training costs for replacement employees.
- Organizational costs as promotions created a ripple effect down through agencies.
- An increase in the number of employee grievances attributed to hiring inexperienced managers.
- An unexpected exodus of experienced, key employees.

The advantages remain:

- With careful design, early retirement incentives can assist in the smooth and economical downsizing of government.
- Incentives help avoid the disadvantages of involuntary dismissals and allow a graceful end to careers in government.
- Incentives make room for new ideas and management practices.
- With targeting, control of replacements and better reporting on vacancies than is the ordinary rule, early retirement incentive programs can save money.

Privatization as a Means of Reducing State Employee Numbers

Privatization includes a broad range of concepts, from asset sales to the use of volunteers, with its emphasis on replacing government activities with private sector activity. Rationales for privatization range from a conviction that public sector activities ought to be minimal, for reasons of both economic efficiency and personal liberty, to the views that introducing competitiveness to government may improve efficiency, save some money or reduce hostility to government. The discussion here focuses on the connections between privatization and employment issues.[5]

The most widespread form of privatization is contracting for services, long a practice in state and local governments. According to state officials, the reasons that privatization will expand are, in order of importance:

- Cost savings;
- Lack of agency personnel or expertise;
- Flexibility;

- Speedy implementation; and
- High-quality services.

Privatization in the form of contracting out for services is far more widespread in state and local government than advocates of privatization sometimes may realize. As long ago as 1982, state and local contracts let to private vendors amounted to $65 billion, well over 10 percent of spending for that year.[6] Private sector contracts accounted for between 18 percent and 20 percent of Colorado state expenditures (other than higher education expenditures) in FY 1986, FY 1987 and FY 1988. In FY 1988, social services contracts accounted for somewhat less than half of the total contractual spending, and highway construction and maintenance for another third. A study of Minnesota state government's contracts for FY 1990 reported $496 million in contracts, of which 78 percent was construction of highways and bridges.[7]

Some authorities contend that contracting for services saves money because the private sector tends to pay less and provides fewer benefits than public employment.

> When comparisons are made of total compensation, not just wages, and are confined to low paying jobs (e.g., janitorial and food services), public sector workers make much more. Many claimed savings from privatization build on the [compensation] differences, not on productivity differences.[8]

Others find different reasons for private-sector costs being lower than those in the public sector. According to the Council of State Governments:

> Savings from competitive contracting of public services could be due to the fact that private firms give fewer days off with full pay; use more part-time workers; have great managerial authority to hire and reward good workers, and, if necessary, to discipline or fire unsatisfactory ones; utilize more productive equipment; have clearer job definitions and greater accountability; and have more workers per supervisor. State managers may want to consider similar tools of management improvement.[9]

However, Albert Shanker, president of the American Federation of Teachers, warns:

> Contractors often make their money by lowering wages and cutting benefits. Low-wage workers with no benefits can end up eligible for food stamps, public housing and public medical services, all costs to the community.[10]

Guidelines for Privatization

When services are available on the open market, what services should governments try to produce internally and what should it obtain from the market? One study suggests use of a contractor when:

- The workload or funding is likely to vary;
- New equipment, specialized personnel or significant capital investment are required;
- Service sites are scattered throughout the state; or
- Others can provide greater value or service levels than state employees.

The study recommends retaining a service as part of state government when:

- Employees provide the service incidentally as part of their routine activities;

- The state investment in facilities or equipment remains useful;
- The activities are tied closely to an agency's basic mission; or
- The activities help to fund the agency or reduce costs or otherwise are important to running the agency.[11]

Case Study: The Massachusetts Privatization Law

The Massachusetts legislature in 1993 enacted legislation over the governor's veto to prevent potential private contractors from greatly reducing salaries and benefits from the public employee level. The effect of the legislation is to require potential contractors to show they can find efficiency savings other than in salaries and benefits and at the same time provide the quality of service government employees can provide. The Massachusetts law provides that:

- Contractors must provide health insurance benefits comparable to those for similarly paid positions in state government.
- Contractors must offer positions created by the contract to state employees whose jobs are lost because of the contract.
- Agencies must estimate the cost of their providing the services that are the subject of the contract and provide for state employees' unions or other organizations to bid against external bidders.
- Agencies must certify that the cost of contracting out is less than the cost of internally producing the services in question.
- The state auditor's statement that the law has been observed will be necessary in order for a contract to be valid.

These provisions almost require a contractor to demonstrate savings in service delivery from some source other than reduced employee compensation—the guidelines allow only a limited reduction in compensation. The guidelines also encourage government employees to compete with potential private contractors.

No contract was submitted to the Massachusetts State Auditor for review from the time the law was enacted in December 1993 through April 1996. In April 1996 the auditor's office indicated it expected the Massachusetts Bay Transit Authority, which operates trains and buses in eastern Massachusetts, to submit a number of proposals for contracting for various management and maintenance operations. No other proposals appeared to be in progress. This suggests that potential contractors have found it difficult to demonstrate the advantages of contracting and that, without significant reductions in salaries, wages and benefits, savings from contracting are hard to find.

Case Study: Experience with Privatization in Minnesota and Wisconsin

State audits offer case studies that demonstrate it is impossible to generalize broadly on the point whether contracting out can save money. In cases when the private sector already provides a service similar or identical to one provided by government and does so at a similar or less cost, privatization can make good sense. As the following studies show, comparisons are not always clear-cut.

Janitorial services. Custodial and maintenance services may be provided by contract more often than any other service used by state government. A Wisconsin audit found that the average cost for cleaning in 1988-89 was $0.84 per square foot in buildings

cleaned by contract and $1.61 per square foot (92 percent more) in buildings cleaned by state employees. The difference was ascribed to contractors' lower wages and fewer workers for a given area, though the report noted quality problems with the contractual work.[12]

Nursing and nursing home care. In the late 1980s, the costs of contractual nursing at a university hospital and at a Wisconsin state penitentiary were about twice as much as the cost of state-employed nurses at those institutions. This was in part because state salaries were so low that the state was unable to attract enough employees. Hospital officials were then designing new classifications and employment practices intended to attract more employees but still keep costs below contractual employee costs.[13]

A Minnesota comparison of public and private nursing home costs in 1988-89 found that the costs of similar services were about 40 percent higher in the publicly operated nursing homes. Repair and maintenance needs of large, old state facilities and the greater number of state residents who needed more intensive care accounted for part of the cost. But the main cause of the difference was that salaries in private nursing homes were from 20 percent to 40 percent lower than state salaries. Private nursing homes also used somewhat fewer staff per patient, though remaining substantially above state Department of Health minimum requirements.[14]

Printing. A Minnesota study noted, "Minnesota's printing service has been plagued by inefficiencies, including high prices, poor quality and delays," and weighed the possibility of eliminating the service or reducing its size.[15] Despite those charges, the study found that state agency prices tended to be lower than private sector prices, although they were not far apart at the low end. The study also found that the printing agency developed valuable recycling techniques that other printers copied, probably helped small state agencies save on printing costs by providing expertise and exercised some required controls over printed state documents (like the exclusion of advertising of an individual). Thus, the printing agency provided important services that would be hard to contract for if its printing responsibilities were contracted out.

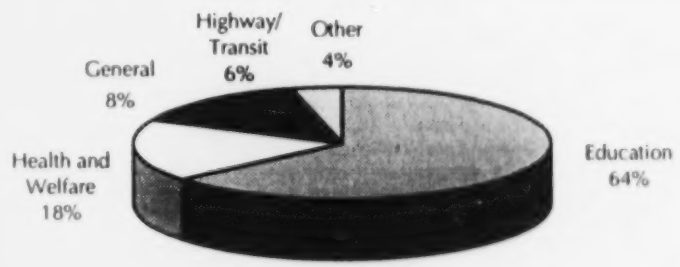
Other state activities. Activities that the Minnesota and Wisconsin studies recommended for possible privatization included computer programming, food services at universities and a variety of services at prisons, including food services, laundry, counseling, health services and industry product marketing. On the other hand, the Minnesota study also found state activities with counterparts in the private sector that it advised the state to retain—including fish hatcheries and tree nurseries.[16]

State Aid to Local Governments

State aid to local governments—counties, municipalities, school districts and special districts—amounted to about $200 billion in FY 1992. As shown in figure 3 earlier in this chapter, aid to local governments represents almost 30 percent of state spending. As shown in figure 4, most of this aid—64 percent—was for education. Those two facts set the parameters of any discussion of reductions in aid to local government as a means of dealing with a state government budget problem: Intergovernmental aid is a very large part of state budgets, but most of it is for education, which usually is immune to budget cuts.

There are two basic ways for state governments in fiscal distress to reduce aid to local governments:

Figure 4. State Aid to Local Governments, FY 1992



Source: NCSL compilation based on Census Bureau reports

- Squeeze the cuts out of the share of state aid for purposes other than support to education (an amount that varies greatly from state to state). This often has meant reductions in state general-purpose aid to local governments—aid not earmarked for a particular expenditure.
- Replace some fraction of state government aid to education with funding from another source.

Both practices impose hardships on local governments, especially because most local governments have limited authority to raise additional revenue. Both practices are likely to undermine one of the functions of state aid to localities, which is to compensate for local or regional differences in wealth and tax bases within a state.[17]

Case Study: New York's Experience With Reductions in State Revenue Sharing

New York provides unrestricted state aid, called revenue sharing, to the general purpose governments in the state: counties, cities, towns and villages. State statute dedicates 8 percent of state revenues to these local governments as unrestricted aid, but state fiscal conditions in recent years have resulted in suspension of the statute and in allocations well below that level. Reductions over a number of years have cut the allocation to about 50 percent of the FY 1987 amount and to about 15 percent of the (potential) statutory level.

The state revised its general revenue-sharing formula for FY 1987 to take population changes into account and established a formula for allocations to the four kinds of local government. The formula included population and wealth indicators. In FY 1987 the state distributed a little over $1 billion in revenue sharing. The distribution remained frozen through FY 1989, but when fiscal conditions began to deteriorate significantly in FY 1990, the state began a series of reductions intended to help balance the state budget. The amount proposed in the governor's budget for FY 1997 is $530 million. The formula would produce between $3.5 billion and $4 billion if it were in effect.

These are the events that have significantly reduced revenue sharing in New York since 1989:

- For FY 1990, the state eliminated revenue sharing for counties and held it constant for cities, towns and villages.
- For FY 1991, in the course of the fiscal year, the state (1) imposed a 1 percent across-the-board reduction for all recipients except New York City; (2) imposed an additional 10 percent reduction in midyear when it looked as though the deficit would be $4 billion; and (3) imposed a third reduction to allow the state to recapture funds that local governments saved because of a change in required contributions to employee pension systems. (The courts later overturned the amended contribution rate as unconstitutional, and local governments are in the

process of making up the reduced contributions. The state has not compensated local governments for the revenue it took back in 1991.)

- For FY 1992, revenue sharing was first set at 60 percent of the FY 1990 amounts, with counties still excluded, but later cuts substantially reduced the amounts local governments received.
- For FY 1993 and FY 1994, funding was at 84 percent of the FY 1992 level, which put it between 45 percent and 50 percent of the FY 1988 level for the governments that still received it.
- For FY 1995, amounts were increased by 7.6 percent and have remained at that level. Although an increase was proposed for FY 1996, it could not be funded, and the governor has recommended the same amount of funding for FY 1997 as localities received in FY 1995.

The elimination of revenue sharing has posed fiscal problems for counties, which in New York are responsible for providing 50 percent of the match that the federal government requires for Medicaid and AFDC and half of state costs for general assistance. Costs for these programs have increased since county revenue sharing ended. As a result, counties have generally increased their sales taxes to the maximum 3 percent level general law allows (on top of the state's 4 percent), and some counties have received permission from the state to add a fourth percentage point.

Cities' difficulties in replacing the lost revenue sharing has depended on the flexibility of their tax bases. They have tended to rely more on increases in fees and charges than on property tax increases. The legislature also has been faced with an increasing number of requests for special financial assistance. In the state's history the legislature had received only an estimated 60 such requests. In 1992 alone there were 11 requests made by local governments for special financial assistance.

Proposals for state tax cuts and property tax reductions make it unlikely that the state will increase revenue sharing substantially in the near future.

Case Study: California's Experience with Reductions in State Aid to Education

In FY 1993 and FY 1994, California addressed multibillion dollar budget shortfalls by, among other things, reducing its general fund allocations to public schools by about $4 billion. This money was made up by shifting about $4 billion in property tax collections from cities, counties and other local governments to school districts. Neither the overall level of property taxation nor the level of school funding were altered by the property tax shift.[18]

The shift was possible because Proposition 13, the 1978 constitutional amendment that rolled back and capped property taxes in California, required the legislature to reallocate remaining property tax revenues to the counties, cities, school districts and special districts that had received them in the past. Thus, the distribution of property tax revenue among local governments is determined by statute, not by the constitution, and is subject to change by the governor and the legislature. The 1993 legislation had the unusual effect of reversing the trend of the state assuming a greater state share of public school funding, a trend nationally as well as in California.

The lion's share of the shift came from county government, whose lost property tax revenues composed 76 percent of the shift in FY 1994 and an estimated 71 percent in FY 1995, with the counties' loss increasing from $2 billion in FY 1994 to $2.6 billion in

FY 1995. Losses of this magnitude have posed serious problems for the counties because of their responsibilities in law enforcement, health and welfare programs. Cities were less affected because they lost less revenue and because they had alternative options for raising revenue.

The county losses were partially offset by voter-approved Proposition 172 , which increased the state sales tax by one-half cent, raising $1.6 billion earmarked for law enforcement programs (a small share went to city programs). The legislature also provided a way for fiscally stressed counties to reduce their general assistance grants.

Despite the offsets, many local programs other than education and law enforcement have faced cuts of as much as 50 percent. Counties' reduced reliance on property taxes and their reduced funding have caused them to neglect property tax administration and enforcement. Tax increases would require legislative authorization (except for some minor exceptions) and approval of at least a majority of the voters.

The California Legislative Analyst's Office has recommended that the legislature reverse the property tax shift, pointing out that it was based on "extreme fiscal conditions" the state faced, not on a policy choice.

Notes:

1. State spending for salaries and wages was $112.7 billion plus 25 percent of that amount added as an allowance for fringe benefits. State current operations cost $322 billion in FY 1992. State/local total for salaries and wages was $383.2 billion and in the text is adjusted by a factor of 25 percent for fringe benefits. Total direct expenditure for current operations was $824 billion. *(Government Finances 1991-1992, Preliminary Report*, page 1.)

2. "State and Local Employment Growth," *State Policy Reports*, 14, no. 3, Feb. 1996: 4-14.

3. Ibid., 11.

4. State of Maine, Productivity Realization Task Force, *Summary Report: Enhancing Productivity in Maine State Government* (Augusta, Maine: June 1996).

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6. Donald F. Kettl, *Sharing Power: Public Governance and Private Markets* (Washington, D.C.: The Brookings Institution, 1993): 156.

7. State of Colorado, Office of the State Auditor, *Privatization in Colorado State Government: Follow-Up Performance Audit* (Denver, Colo.: February 1993); *Privatization in Colorado State Government: Performance Audit* (March 1989); State of Minnesota, Office of the Legislative Auditor, Program Evaluation Division, *State Contracting for Professional/Technical Services* (St. Paul, Minn.: February 1992).

8. Hal Hovey, "Public Employees Under Attack," *State Policy Reports* 12, no. 5 (Mary 1994): 2-3.

9. Keon S. Chi, "Privatization in State Government: Options for the Future," *State Trends Forecasts* 2, no. 2 (November 1993) : 26.

10. "Does Privatization Work?" (paid advertisement), *State Legislatures* 21, no. 5 (May 1995): 28.

11. Minnesota, *Contracting for Services*, 81-82.

12. State of Wisconsin, Legislative Audit Bureau, *An Evaluation of Privatization of Government Services* (Madison, Wis., June 1990): 12-18; tables reporting state government use of contracting printed in Chi, "Privatization in State Government," 34, suggest that custodial and maintenance services are among the most frequently contracted out.

13. Wisconsin Legislative Audit Bureau, *Evaluation of Privatization*, 24-29.

14. Minnesota, *Contracting for Services*, 52-59.

15. Minnesota, *Contracting for Services*, 67-71.

16. Minnesota, *Contracting for Services*, 59-67, 72-75; Wisconsin Legislative Audit Bureau, *Evaluation of Privatization*, 33-36.

17. A good general survey of the topic is Steven D. Gold and Sarah Ritchie, *State Action Affecting Cities and Counties, 1990-1993: De Facto Federalism* (Albany: State University of New York, Center for the Study of the States, April 1994): 23.

18. Legislative Analyst, *Reversing the Property Tax Shifts: Policy Brief* (Sacramento: The California Legislature, April 1996).

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